Issues Paper

AASB ED 250 (IASB ED/2014/2) *Investment Entities: Applying the Consolidation Exception*

Introduction

1 The purpose of this paper is to consider the proposals and potential issues in ED 250 *Investment Entities: Applying the Consolidation Exception* and decide whether these issues, or any other issues, should be included in the AASB's submission on IASB ED/2014/2. This paper is structured to correspond to the questions in ED/2014/2.

2 The discussion of the issues raised in this paper incorporates feedback from targeted discussions with five constituents: two Big 4 accounting firms, two preparers of financial statements and one user of financial statements.

3 The AASB received one submission in response to ED 250 and the respondent was generally supportive of ED 250's proposals.

4 Staff will raise at the Board meeting any further significant issues raised in any submissions received and outreach meetings held subsequent to finalising this paper.

Question 1— Exemption from preparing consolidated financial statements[1][2]
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?

Responses to AASB staff outreach

5 Most respondents to the targeted outreach were broadly positive about the exemption. They considered 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 Consolidated Financial Statements. Consequently, if one of the subsidiaries is itself 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. Most also consider that requiring an intermediate parent (which is a subsidiary of an investment entity parent) to present consolidated financial statements would be contrary to the IASB's intention in providing the consolidation

1 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. This is to align the "consolidation" exemption in paragraph 4(a) with the corresponding exemption in IAS 28.

2 Note that the proposed amendment to paragraph 4(a) of IFRS 10, which would be incorporated in AASB 10 if the amendment is finalised, would require the amendment or removal of paragraph Aus4.2 of AASB 10. This is discussed in more detail in Agenda Paper 9.1 of the September 2014 AASB meeting.

exception to investment entities. However, these respondents also noted that they were not aware of group structures in Australia with an investment entity parent and a non-investment entity subsidiary that is also an intermediate parent.

6 One respondent to the targeted outreach commented that the proposals make sense if the intermediate parent is also an investment entity. However, if the intermediate parent is a non-investment entity, it should be required to prepare consolidated financial statements as that would be the most relevant and useful information for the users of the intermediate parent's group. This respondent commented that group structures involving an investment entity parent and intermediate non-investment entity parent could be found in the superannuation and asset management industries, where the intermediate parent could be a fund administrator or fund manager.

Preliminary AASB staff views

7 AASB staff question whether it is appropriate for an intermediate parent to qualify for the exemption from the requirement to prepare consolidated financial statements if the intermediate parent is not itself an investment entity. The IASB had decided to provide an exception to consolidation for investment entities because of their unique business model. A non-investment entity intermediate parent does not have this unique business model. It has other substantial activities besides investing, or does not manage substantially all of its assets on a fair value basis. Consequently, exempting such a non-investment entity intermediate parent from preparing consolidated financial statements could result in the loss of relevant information. AASB staff note the IASB cited similar reasons, in paragraph BC278[3] of IFRS 10, for requiring a non-investment entity parent to consolidate all of its subsidiaries, including its investment entity subsidiaries.

8 Staff also note that the exemption for intermediate parent entities was previously provided because the combination of information available in the consolidated financial statements of a higher level parent and the separate financial statements of the intermediate parent entity, together with the conditions in paragraph 4 of IFRS 10, provide sufficient safeguards for the users of the intermediate parent's financial statements (refer to paragraph BC3 of the ED). Such safeguards would not be available for users of a non-investment entity intermediate parent's financial statements if the proposals in Question 1 applied as a non-investment entity intermediate parent would be fair valued in the investment entity parent's financial statement and no consolidated information would be available higher up in the group. Consequently, staff consider that 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.

9 Staff are also concerned that the proposed exemption could increase structuring opportunities to hide leverage or loss-making activities as an intermediate non-investment parent entity would avoid consolidation by having an ultimate investment entity parent.

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[3] The Board has decided to provide an exception to consolidation because of the unique business model of investment entities. Non-investment entities do not have this unique business model; they have other substantial activities besides investing, or do not manage substantially all of their assets on a fair value basis. Consequently, the argument for a fair value measurement requirement is weakened at a non-investment entity level.

Question 1 to the Board **Does the Board agree with AASB staff views in paragraphs 7–9 above?**

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?

Responses to AASB staff outreach

10 A majority of respondents to the targeted outreach were broadly supportive of the proposals and agreed 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.

11 Two respondents to the targeted outreach were concerned that the assessment of the "main purpose" of a subsidiary that was an investment entity and also provided support services to its investment entity parent could require significant judgement in practice. Another respondent suggested that the IASB provide more clarification to the term '*support services that relate to the investment entity's investment activities*' to help with the assessment of the main purpose of a subsidiary.

12 One respondent was concerned that the proposals could give rise to structuring opportunities and preferred the approach considered by the IASB in paragraph BC8(a) of the ED, which is to require an investment entity parent to consolidate an investment entity subsidiary that provides investment-related services to third parties. In this consolidation, the parent would account for each line item in the subsidiary using uniform accounting policies, which would include measuring the subsidiary's investments in controlled investees at fair value.

Preliminary AASB staff views

13 AASB staff can accept the proposals as being consistent with the IASB's previous decision not to create an exception to the fair value measurement requirements for all subsidiaries that are themselves investment entities. Staff acknowledge that the assessment of the main purpose of a subsidiary that is both an investment entity and provides support services that relate to the investment entity parent's investment activities could be quite judgemental. However, staff accept the IASB's views in paragraph BC9(b) of the ED that if an subsidiary qualifies as an investment entity, its business purpose is to invest funds solely for returns for capital appreciation, investment income or both. This means that performing investment-related services that support the investment entity parent's investment activities cannot be its main

activity. Consequently, such a subsidiary should be fair valued and not consolidated under the limited exception in paragraph 32 of IFRS 10.

Question 2 to the Board
Does the Board agree with AASB staff views in paragraph 13 above?

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?

Responses to AASB staff outreach

14 Most respondents to the targeted outreach did not support the proposals in Question 3 and commented that an investor should apply the equity method using the same approach for both an investment entity associate and its subsidiaries and an investment entity joint venture and its subsidiaries. They supported the approach that would require a non-investment entity investor to apply the equity method whilst retaining the fair value measurement applied by an investment entity associate/joint venture to its underlying subsidiaries as they considered that, at the investment entity level (i.e. associate or joint venture), the measurement of the underlying subsidiaries at fair value is appropriate. Most respondents also did not think that it is easier to get consolidation information from an investment entity joint venture compared to an investment entity associate.

15 Two respondents that supported retaining the fair value measurement at the investment entity associate/joint venture level commented that such an approach should also be applied when a non-investment entity parent consolidates its investment entity subsidiaries. In other words, they considered that if an appropriate clear principle and criteria are established at the investment entity level, they should carry-over to the consolidated financial statements of a non-investment entity parent/investor. One respondent also commented that users of financial statements may find the distinction between a joint venture and an associate quite subtle and may be confused by the different approaches applied to determine the carrying value of these investments using the equity method. Another respondent commented that the difference between unwinding the fair value measurement and applying the equity method and not unwinding the fair value measurement and applying the equity method may be marginal in most cases and therefore the time and cost involved in unwinding the fair

value and applying consolidation procedures prior to applying the equity method would not commensurate with the benefits.

16 One respondent noted that when there is a change in status of an investment from an associate to joint venture (or vice versa), IAS 28 requires that the entity continues to apply the equity method and does not remeasure the retained interest[4]. This is, however, inconsistent with the proposed amendments, which would require a 'remeasurement' or a change in the approach of applying the equity method in instances when an investment in an associate changes status to an investment in a joint venture (or vice versa).

17 One respondent that did not support the proposals relating to Question 3 preferred that a non-investment entity investor applies the equity method to both its investment entity associate and joint venture after unwinding the fair value measurement of the underlying subsidiaries and applying the consolidation procedures. In other words, this respondent preferred a single approach of applying the equity method for both associates and joint ventures and considered that the single approach should be not to retain the fair value measurement of the investment entity associate and joint venture to its underlying subsidiaries, consistent with the approach taken by a non-investment entity parent to its investment entity subsidiaries. This respondent did not think that it was practically more difficult for an associate to get the necessary information to apply consolidation procedures to its underlying subsidiaries compared to a joint venture. This respondent also commented that if the IASB wanted to give entities a choice in the manner in which the equity method was applied, then entities should be allowed to choose between (i) unwinding the fair value measurement and applying consolidation procedures or (ii) retaining fair value measurement and applying it consistently for both its associates and joint ventures.

18 Most of the respondents to the targeted outreach noted that they were not aware of structures in Australia where an investment entity is a joint venture.

Preliminary AASB staff views

19 AASB staff do not agree with the proposed amendments relating to Question 3(b), and consider that a non-investment entity investor should apply the equity method to the group financial statements of an investment entity investee (be it an associate or joint venture) without any adjustments to unwind the fair value measurement of the investee's subsidiary. This would be consistent with the guidance in paragraph 27 of IAS 28.[5]

20 An investment entity investee (for example an associate or joint venture) invests in subsidiaries with an investment entity objective, which is different from the objective of a non-investment entity investor when it invests in subsidiaries. Therefore the investments in subsidiaries of an investee that is an investment entity are not 'like

4 Paragraph 24 of IAS 28 states: "If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest".

5 Paragraph 27 of IAS 28 states "When an associate or a joint venture has subsidiaries, associates or joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's financial statements [. . .] after any adjustments necessary to give effect to uniform accounting policies (see paragraphs 35 and 36)"

transactions or events' compared with investments in subsidiaries of a non-investment entity investor. Staff consider that the assessment of 'like transactions and events' is different when applying the equity method compared to the process of consolidation because associates and joint ventures are not being consolidated as part of the investor's group.

21 AASB staff note that paragraph BC34 of IFRS 11 *Joint Arrangements* states: "… the Board observed that the term 'net assets' in the definition of joint ventures aimed to portray that the joint venturers have rights to an investment in the arrangement …" and paragraph BC35 of IFRS 11 states: "… the Board clarified that the unit of account of a joint arrangement is the activity that two or more parties have agreed to control jointly …Consequently, the term 'joint venture' refers to a jointly controlled activity in which the parties have an investment." In other words, the unit of account for a joint venture is the investment as a whole and not the underlying assets and liabilities of the joint venture.

22 AASB staff also note that in paragraph BC41 of IFRS 11, the IASB "… concluded that, except for specific circumstances that are addressed in IAS 28 (as amended in 2011), the equity method is the most appropriate method to account for joint ventures because it is a method that accounts for an entity's interest in the net assets of an investee". Therefore, AASB staff consider that introducing a different approach of applying the equity method to an associate compared to a joint venture would not be aligned with the underlying view in IFRS 11. Consequently, the same approach to the equity method should be applied by both associates and joint ventures and this approach should be to retain the fair value measurement by an investment entity associate or joint venture to its underlying subsidiaries as this is consistent with the interest in 'net assets', i.e. the interest in investment approach.

23 Based on the above analysis, AASB staff do not consider that the fair value measurement of an investment entity joint venture or associate's subsidiaries should be unwound before applying the equity method.

24 AASB staff also consider that the IFRS 10 guidance to unwind the fair value measurement of investment entity subsidiaries in the consolidated financial statements of a non-investment entity parent is not relevant when considering the application of the equity method. This is because the equity method is about accounting for an investment whereas consolidation is the process of aggregating the assets, liabilities, income and expenses for the purposes of presenting the members of a group as a single economic entity.

Question 3 to the Board

Does the Board agree with AASB staff views in paragraph 19–24 above?