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Australian Accounting Standards Board

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Mr Hans Hoogervorst
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Dear Hans

ED/2011/4 *Investment Entities*

The Australian Accounting Standards Board (AASB) welcomes the opportunity to provide comments on ED/2011/4 *Investment Entities*. In formulating its comments, the AASB sought and considered the views of Australian constituents through comment letters and other consultation. The comment letters received are published on the AASB's website.

The AASB members have deep concerns about the proposals from at least one of two perspectives.

All AASB members are most concerned about the lack of an underlying principle for the proposals. The AASB believes they could well lead to inconsistent reporting by entities with substantially the same activities. The proposed criteria for identifying investment entities are rule-based and would provide many opportunities for entities to structure their activities to achieve particular accounting outcomes. This would severely hamper the efforts of users to compare the financial statements of entities with similar activities and significantly undermine the credibility of IFRS as a global set of standards.

Consistent with the alternative views expressed by IASB members who dissented from the ED/2011/4 proposals. a significant number of AASB members are opposed to any exception from the principle that entities consolidate the assets and liabilities they control. The proposals are in direct conflict with the IASB's *Conceptual Framework* under which consistency demands the use of the same accounting policies for the same items, both from period-to-period within a reporting entity or in a single period across entities. They consider that, if IFRS departs from this principle, users would be deprived of an overall picture of investment entities' resources and how they have been deployed and the relevant revenues and expenses they have generated. They believe that, if fair value information is particularly significant for a certain class of entity, such information should be disclosed and not be a substitute for consolidation. Moreover, they do not believe there is any significant problem with existing Australian reporting that would warrant such a different outcome as would flow from the proposals.

An equally significant number of AASB members could support having a departure from consolidation, but only if it could be made principle-based. However, those AASB members are aware that it would be extremely difficult for the IASB to promulgate an entity-based exception that is workable at a global level. In this respect, the AASB notes that the existing examples of consolidation exceptions are at a national level where legislation or other domestic requirements are able to identify separate classes of entities about which there is a shared understanding in the domestic context.

If the IASB were to persist with a rules-based exception, the AASB would generally support the proposed anti-abuse restrictions in the interests of limiting the extent of the exception. This is notwithstanding that those anti-abuse restrictions are themselves rule-based.

The AASB is also concerned about proposed changes to the scope of the application of equity accounting. The AASB notes that, under the proposals, many entities that can presently choose to fair value investees would be required to apply equity accounting because they would not meet the investment entity criteria. The IASB has recently undertaken considerable work on control and consolidation and on the fair value measurement basis. However, it is yet to undertake any fundamental reconsideration of equity accounting. For example, it is presently not clear under IFRS whether equity accounting is an adjustment of cost measurement or a measurement basis in its own right.

Accordingly, the AASB considers that it would be premature to extend the required use of equity accounting without establishing the circumstances in which it might lead to the presentation of useful information in financial statements.

Further comments on these concerns and responses to the other questions in ED/2011/4 are included in the attached Appendix.

Yours sincerely

K.M. Stevenson

Kevin M. Stevenson
Chairman

Appendix – responses to ED/2011/4 *Investment Entities*

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?

Some members of the AASB strongly disagree that there is such a class of entity and believe there should never be an exception from consolidating controlled entities.

Consolidation is a basic principle that underpins general purpose financial reporting. Without consolidation, users would be deprived of an overall picture of investment entities' resources and how they have been deployed and the relevant revenues and expenses they have generated. They see no reason not to recognise controlled assets, nor to omit the liabilities of an entity.

These members believe that, if fair value information is considered particularly significant for a certain class of entity, then it should be required to be disclosed and not be a substitute for consolidation.

The proposal to identify certain types of entity for a particular accounting treatment is not consistent with the IASB's long-standing practice of transaction-based standard setting.

Chapter 3 of the IASB's *Conceptual Framework* (2010) notes the following in relation to comparability (underlining is added for emphasis):

> QC20 Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.
>
> QC21 Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items.
>
> QC22 Consistency, although related to comparability, is not the same. <u>Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities.</u> Comparability is the goal; consistency helps to achieve that goal.
>
> QC25 Although a single economic phenomenon can be faithfully represented in multiple ways, <u>permitting alternative accounting methods for the same economic phenomenon diminishes comparability</u>.

The IASB has not established why it should depart from this aspect of its *Conceptual Framework*.

The IASB's ED/2010/2 *Conceptual Framework for Financial Reporting – The Reporting Entity* states at paragraph S2:

> An entity controls another entity when it has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself. If an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements.

The IASB has not provided a rationale for departing from this fundamental concept.

Other AASB members would permit an exception on the basis that they consider fair value information is more relevant than consolidated information for certain entities that are managed on the basis of fair values. They consider that consolidated information does not add useful information beyond that which would be provided by fair valuing controlled entities.

However, these AASB members are also concerned that the proposed rule-based criteria for identifying investment entities would provide many opportunities for entities to structure their activities to achieve particular accounting outcomes, which would hamper the efforts of users to compare the financial statements of entities with similar activities. These AASB members do not support an exception from consolidation in the absence of a principle-based definition.

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?

The AASB considers that the criteria are rule-based and therefore inappropriate because they will inevitably result in inconsistent outcomes in similar economic circumstances.

A principle-based definition of ‘investment entity’, if one could be devised, would be preferable. However, the AASB believes it would be extremely difficult to promulgate an entity-based exception in a global context and notes that the existing examples of consolidation exceptions are at a national level where legislation or other domestic requirements are able to identify separate classes of entities. Constituents within those national jurisdictions are able to gain a shared understanding because they have a common understanding of the local regulatory environment. This type of shared understanding is not feasible at an international level.

There are already concerns about the consistent application of IFRS across the globe, and these proposals would exacerbate them.

The AASB notes that criteria (a) and (b) imply the notion of a passive investor. The AASB believes this is completely inconsistent with the whole idea that the basis for identifying a reporting entity is the notion that an investor has the power to act, rather than necessarily acting, in relation to an investee. In other words, the criteria seem to go some distance towards undoing the work recently completed by the Board on de facto control.

Question 3(a)

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?

Why or why not?

If the IASB were to proceed with an exception from consolidation, the AASB does not consider that the management if its own investment activities should make an entity ineligible for the exception.

Question 3(b)

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:

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

Why or why not?

No.

An entity that provides (or holds an investment in an entity that provides) services that relate to its own investment activities, or the investment activities of entities other than the reporting entity, should not be eligible to qualify as an investment entity.

Those AASB members who oppose any exception from consolidation hold this view in the interests of limiting the extent to which entities would not prepare consolidated financial statements. This is notwithstanding the AASB's more general opposition to rule-based criteria.

Question 4

(a) Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not?

(b) 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.

No.

An entity that has only a single investor should not be eligible to qualify as an investment entity. The AASB agrees with the concerns expressed at paragraph BC16 regarding the possible use of the exception by entities to structure activities as 'off balance sheet'. This is notwithstanding the AASB more general opposition to rule-based criteria. The structuring problem really lies with the nature of the proposal to provide an exception from consolidation based on the types of entity involved, rather than a robust principle.

The AASB notes that there could be many different interpretations of when an entity has "investors that are unrelated to the parent (if any), and collectively hold a significant ownership interest in the entity". The notion of 'collectively significant' seems to compete with 'control' and 'significant influence'. The AASB considers it is inappropriate to create such a notion without careful examination of its impacts.

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?

If the IASB were to proceed with an exception from consolidation based on a notion that the entity manages on a fair value basis [criterion (e)], the AASB would expect that the entity would measure investment property at fair value through profit or loss. Fair value measurement would reflect the nature of the asset in that context.

More generally, the AASB believes that the accounting for any assets should be considered in the context of the nature of the relevant assets, rather than in the context of the nature of the entity for the reasons outlined in its comments on Question 1 on ‘transaction-based standard-setting’. That is, the IASB should address this issue in the context of accounting for investment properties rather than the accounting by particular types of entities.

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?

Yes.

The AASB considers 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.

The AASB believes that this restriction is essential to help avoid structuring designed to achieve particular accounting outcomes.

Furthermore, if the exception were to flow up into the consolidated financial statements of the parent, it would be inconsistent with the whole focus of ED/2011/4 on entities that meet the investment entity criteria. That is, the AASB can understand that the accounting for a particular type of transaction or item might flow up into higher levels of a group, but not when the accounting policy depends on the nature of the entity itself.

Question 7

(a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements?

(b) 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?

In the context of the proposals, the AASB considers the disclosure objective and related guidance to be the minimum that should be required. Those AASB members who oppose the exception from consolidation believe detailed disclosures of the assets, liabilities, revenues and expenses not recognised due to the exception should be required to be disclosed. In particular, they do not wish to see a fair value amount (a net value) obscuring what underlies that amount. The size of a fair value amount may bear little relationship to the size of underlying off-balance-sheet assets and liabilities.

As noted in response to Question 1, those AASB members who oppose any exception from consolidation believe that, if fair value information is considered particularly significant for a certain class of entity, then it should be required to be disclosed and not be a substitute for consolidation.

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 instead and why?

In the context of the proposals, the AASB considers the proposed transitional arrangements to be reasonable.

Question 9

(a) 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?

No.

The IASB has recently undertaken considerable work on control and consolidation and on the fair value measurement basis. However, it is yet to undertake any fundamental reconsideration of equity accounting. For example, it is presently not clear under IFRS whether equity accounting is an adjustment of cost measurement or a measurement basis in its own right.

The AASB considers that it would be premature to effectively extend the required use of equity accounting without establishing the circumstances in which it might lead to the presentation of useful information in financial statements.

The AASB notes that paragraph BC29 of ED/2011/4 acknowledges the proposal "… might cause fewer entities to be able to measure their investments in joint ventures and associates at fair value through profit or loss, even though in its view this measurement might produce, for some of those entities, more relevant information to users of financial statements than measuring the investments by the equity method.".

The proposed change to the exemption would have far-reaching implications for many Australian reporting entities. For example, in the interests of attaining as much consistency in accounting for the assets of insurers as feasible within IFRS, the AASB's insurance standards (which build on IFRS 4 *Insurance Contracts*) require insurers to fair value essentially all their interests in associates and joint ventures where they fall into the existing IAS 28 scope exemption. The proposals would put an end to this consistency.

If the IASB were to proceed with an exception from consolidation, and it wants to require an investment entity to account for all of its assets at fair value through profit or loss, it should do so directly, rather than by amending the scope exemption in IAS 28.

Question 9

(b) 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?

Relative to the proposal at Question 9(b), the AASB would prefer the approach outlined in Question 9(b), even though it would maintain an optional accounting treatment. This is because the approach is less pre-emptive of the thorough review that should be done of the usefulness and application of equity accounting. That is, in the absence of a thorough review by the IASB that examines whether there are circumstances in which equity accounting might lead to the presentation of useful information in financial statements, its existing scope of application should not be extended.

Also see the AASB's last comment under Question 9(a).