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The Chairman  
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17 January 2012

Dear Mr Stevenson

**Invitation to comment - Exposure Draft ED/2011/4 Investment Entities**

Please find enclosed Ernst & Young's letter to the IASB dated 13 January 2012 re Invitation to comment - Exposure Draft ED/2011/4 Investment Entities.

This letter is being provided as referred to in our letter to the AASB dated 13 December 2011.

Yours sincerely

A handwritten signature in blue ink that reads 'Ernst &amp; Young'.

Ernst & Young

Encl:



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13 January 2012

**COPY**

Dear IASB members

**Invitation to comment - Exposure Draft ED/2011/4 Investment Entities**

The Global organisation of Ernst & Young is pleased to submit its comments on the above Exposure Draft (ED).

We generally support the proposal of the International Accounting Standards Board ('the IASB') to create an exception to the principle of consolidation in IFRS 10 *Consolidated Financial Statements* and to require a class of entities that, by design invest for purposes of capital appreciation, investment income or both, to measure their controlled investees at fair value through profit or loss.

We note that the proposals in this [draft] IFRS are inconsistent with the concept of control which is fundamental to the preparation and presentation of financial statements. However, the Conceptual Framework also explains that the objective of general purpose financial reporting is to provide decision-useful financial information. Therefore, on balance, we support the exception provided in this [draft] IFRS. Our concerns around the inconsistency with the control concept are outweighed by the fact that the proposed exception offers investment entities the opportunity to provide more decision-useful information to the users of their financial statements. Further, the exception promises convergence with US GAAP.

However, a critical aspect of our support of the proposals would include confirmation of financial statement users' consensus agreement that this provides more decision-useful information. We support the initiative by the IASB and the US Financial Accounting Standards Board ('the FASB')<sup>1</sup> to host roundtables to discuss the implications of the proposals. We strongly urge the IASB to ensure that the users of financial statements and their concerns are the basis for those discussions and any other associated outreach initiatives.

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<sup>1</sup> Collectively referred to in this comment letter as 'the Boards'

We agree with (i) above; that investments in associates and joint ventures should be measured at fair value through profit or loss in the financial statements of an investment entity. However, we cannot see a reason for (ii) above - why other entities that currently apply the exception in IAS 28, and that may not qualify as investment entities, should be forced to record their associates and joint ventures using the equity method. Therefore, we highly recommend that the IASB retain the current policy choice for the types of entities listed in IAS 28.

We encourage the IASB to reconsider the areas of our key concerns listed here and the other aspects addressed in our answers to the specific questions included in Appendix A, as well as achieving convergence of the final standards which will be issued by the IASB and FASB.

Appendix B to this letter includes other observations about the ED that we would like the IASB to consider in its redeliberations.

Should you wish to discuss the contents of this letter with us, please contact Ruth Picker on +44 20 79513497 or Leo van der Tas on +31 88 4075035.

Yours faithfully

*Ernst & Young*

The existence of these mixed views is precisely the reason why we recommend that the Boards should perform additional and specific outreach with financial statement users to confirm that fair value provides the most decision-useful information for all entities that may meet the investment entity criteria.

**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?

We generally agree with the criteria set out in paragraph 2(a) - (f) of this [draft] IFRS. While certain aspects of the criteria could be improved and clarified (as discussed further below), the criteria broadly capture the appropriate pool of entities that would qualify as investment entities. Nonetheless, we expect the threshold to be high for an entity to qualify as an investment entity.

We have the following specific comments and observations with respect to the criteria of paragraph 2 of this [draft] IFRS and the accompanying Application Guidance.

**Para 2 (a) - Substantive activities**Nature of substantive activities

With respect to the guidance in paragraphs B1 and B2, we have the following observations:

- In paragraph B1 the term 'investing activities' is used whereas elsewhere in this [draft] IFRS the term 'investment activities' is used.
- The term 'investing activities' is defined in IAS 7 *Statement of Cash Flows*<sup>3</sup>, however the terms 'investment activities' and 'investment advisory services' are not defined in the draft IFRS.

To avoid diversity in practice, we believe that constituents would benefit from clarity of the extent and boundaries of services that would be acceptable to for the entity to qualify as an investment entity by providing definitions.

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<sup>3</sup> The acquisition and disposal of long-term assets and other investments not included in cash equivalents



Based on the definition of an affiliate in this [draft] IFRS and the guidance in paragraph B6, it seems that it is the intention of the IASB to disallow these kinds of relationships and activities between directly or indirectly controlled investees of the entity. However, we also note that comparable relationships and activities between directly and indirectly held associates and joint ventures of the entity would not preclude the entity from being an investment entity because the respective interests are not defined as affiliates.

We believe that as long as relationships and activities *occur between directly or indirectly controlled investees of the entity* and are consistent with the entity's investment activities, the entity should still meet this criterion.

Therefore, we would suggest that the relationships and activities as described in paragraph B6 (a) - (g) should not be considered to be non-investment activities when they *occur between directly or indirectly controlled investees of the entity* and are consistent with the entity's investment activities.

#### Para 2 (b) - Business purpose

##### Exit strategy

With respect to the exit strategy and the guidance in paragraphs B9 - B11, we have the following comments and observations:

- It is unclear whether a documented exit strategy is required for *each individual investment*, and whether it would be acceptable to have an exit strategy for *most, but not all*, investments? Further, would it be acceptable for an exit strategy *to apply to a portfolio of investments* as is often seen in practice?
- It is unclear whether an exit strategy is required only for those investments where the entity intends to realise capital appreciation, or for all investments? It may be useful to note that the FASB has acknowledged the point by clarifying in its exposure draft (paragraph 946-10-55-10) that entities investing solely for investment income would not be required to have an exit strategy for those investments. While the FASB's clarification is useful, many entities have a mix of investments held individually for both capital appreciation and investment income purposes. We believe that the IASB should consider whether or not the guidance for exit strategy should be applicable only to investments held for capital appreciation purposes.

Refer also to the discussion of the scope of the [draft] IFRS in Appendix B.

Based on these observations we would encourage the IASB to provide more guidance and clarity around the exit strategy to avoid divergent interpretations of this aspect in practice.

We agree that where the investment entity provides investment services outside the reporting entity, the nature of the investment activity criterion would not be met.

However, we also refer to our comments around the criterion 'substantive activities' noted in our answer to question 2.

**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 Boards in paragraph BC16.

4 (a) Single unrelated investor<sup>4</sup>

We are concerned that the requirement to have multiple investors that are unrelated to the entity's parent (if any) could have an unintended consequence of scoping out many funds that would otherwise fall into the definition of an investment entity. It is common for non-investment entities (such as pension funds) to be the sole investor in an investment fund. These investment funds are generally designed to provide the investor additional levels of control over the investment strategy while still having an express purpose of investing for capital appreciation, investment income or both.

Consider the following simple example where parent entity P holds a 60% interest in entity A, and consider the following two scenarios:

- Scenario 1: two investors unrelated to P each hold a 20% interest in A.
- Scenario 2: only one investor unrelated to P holds 40% in A.

We would be interested to understand why in scenario 1, entity A may qualify as an investment entity but may not qualify as an investment entity in scenario 2? We would encourage the IASB to provide additional guidance on this criterion. This is a further example of where user feedback would be critical.

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<sup>4</sup> In answering this question, we assume that 'fund manager' means 'parent' of the investment entity, as per the guidance in paragraphs 2(a) and B14 that requires an investment entity to have "investors that are unrelated to the parent (if any)".



#### 4 (b) Structures/examples and concerns of the IASB

In paragraph BC16 of the Basis for Conclusions the IASB raised the concern “that an investment entity could be inserted into a larger corporate structure to achieve off-balance sheet accounting for some assets, while the parent could own almost all of that investment entity”.

In practice, the following situations and structures may occur where (temporarily or permanently) only a single investor unrelated to the parent exists:

- Structures where the intent is for there to be multiple investors (e.g. start-up entities) or where there have previously been multiple investors but for some reason there is currently only a single investor, but the business purpose of the entity still is to have multiple investors.
- Entities with a single investor that have been organised and set up in contemplation of a related investment entity (e.g. co-investment vehicle) which invests in a number of investments alongside another investment entity.
- Sovereign wealth funds, pensions funds or feeder funds which are likely to have only a single investor but fulfil all the other criteria for an investment entity.

We believe that these situations and structures on their own should not lead to an entity disqualifying as investment entity. In particular, the IASB should focus on the business purpose when evaluating circumstances where there is a single investor. Likewise, when certain structures are used solely to facilitate the investing strategies but do not otherwise alter conclusions about the express business objective and investing activities, the existence of such structures should not be the sole reason why an entity does not qualify as an investment entity.

While we appreciate the IASB’s concern around structuring, we think the focus should be on business purpose when evaluating circumstances where there is a single investor. We are not convinced by the fact that an entity with only one investor would necessarily lead to structuring abuse.

Therefore, we encourage the IASB to focus its concerns around abuse by clarifying the types of structures and activities that would call into question whether an entity is investing for capital appreciation, investment income or both, rather than using a bright-line approach based on the number of investors.

- In Example 2, Investment Entity 1 has inserted Investment Entity 2 between itself and the controlled investments in A, B and C. Based on our understanding of paragraph B16 (as discussed under question 4), Investment Entity 2 could also qualify as an investment entity. Therefore in this example, Investment Entity 1 would recognise its interest in the controlled Investment Entity 2 at fair value through profit or loss.

The FASB sees this differently - that Investment Entity 1 consolidates Investment Entity 2 and measures the investments in A, B and C separately at fair value through profit or loss.

We urge the IASB and FASB to develop converged guidance for these kinds of structures. We recommend that the Boards request user views on this issue as part of the planned round table discussions, to ensure that the final guidance results in a clear principle that is consistently applied.

**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 IASB's concerns?

We strongly disagree that non-investment entity parent entities should not retain the fair value measurement of investees controlled by investment entity subsidiaries in their consolidated financial statements. Our reasons are as follows:

- In BC20 the IASB expressed the view that, in most cases, investment entities would have investment entity parents and therefore investment entity accounting would be available when needed. However, we understand that there are many situations in practice where investment entities are controlled by a parent that does not satisfy the investment entity criteria (e.g. insurance company controlling unit-linked funds; funds controlled by financial institutions, private equity/venture capital entities providing investment services to third parties).
- The IASB proposed this [draft] IFRS on the basis that fair value measurement provides more useful and relevant information for users of the financial statements of investment entities. In BC20, the IASB also acknowledges "that if more useful information is provided by allowing the investment entity to measure controlled investments at fair value it is likely that useful information would also be provided by retaining this accounting in the consolidated financial statements". We agree with this statement, and we do not think the IASB provides a compelling reason why the more useful and relevant information should not be retained in the consolidated financial statements of a non-investment entity parent.



classification as an investment entity. If it does, we think that specific application guidance should be provided to resolve the specific accounting issues. Following the changes made to paragraph 19 of IAS 28 when IFRS 10 was issued, the IASB acknowledges that interests in associates could be held for different purposes. In our view, the same rationale may be used as a starting point to develop specific application guidance to avoid the accounting issues described above.

We would like to highlight that the proposals will already lead to similar accounting issues as described above, for example in the following situations (both examples assume the non-investment company parent is holding its investment for capital appreciation or investment income only and there are no other arrangements that may disqualify the investment entity subsidiary from meeting the definition of an investment entity):

- Non-investment entity parent holds a controlling interest of 60% in an investee and the investment entity subsidiary holds an interest of 30% in the same investee.
- Non-investment entity parent holds an interest of 30% in an investee and the investment entity subsidiary holds an interest of 30% in the same investee and both interests together provide control.

By requiring retention of the fair value measurement of associates and joint ventures of the investment entity subsidiary in the consolidated financial statements of the non-investment entity parent, the IASB does not seem to have the same concerns about accounting anomalies.

2. The accounting by the entity's parent could differ as a result of the parent selectively making investments within an investment entity subsidiary that are similar to investments held by non-investment-entity members of the consolidated group.

This concern seems to indicate that an entity needs to make investments in similar entities for the same purposes. We do not see a basis in IFRSs for this notion.

3. Accounting inconsistencies and possibilities of abuse e.g. when a non-investment entity parent issues its equity to an investee of an investment entity subsidiary and thereby appears to have a stronger capital base.

We believe that the example the IASB is referring to is rather rare in practice and that it does not adequately support the disallowance of the fair value roll-up into the non-investment entity parent's consolidated financial statements. We think that this specific situation may be addressed in additional application guidance.

Regarding the disclosure requirements in other standards, we have the following observations:

- IFRS 7 *Financial Instruments - Disclosures* paragraph 3(a) scopes out those investments in subsidiaries, associates or joint ventures accounted for in accordance with IAS 27 *Consolidated and Separate Financial Statements*/IFRS 10, IAS 28 or IAS 31 *Interests in Joint Ventures*/IFRS 11 *Joint Arrangements*, except for those that are accounted for under IAS 39/IFRS 9, as permitted in some cases.
- IFRS 12 *Disclosure of Interests in Other Entities* paragraph 6(d) scopes out interests in another entity that are accounted for in accordance with IFRS 9. However, IFRS 12 shall be applied when that interest is an interest in an associate or joint venture that, in accordance with IAS 28 is measured at fair value through profit and loss.
- Paragraph 6 of this [draft] IFRS and the consequential amendment to IAS 28 refer to the **measurement** of controlled investees and interests in associates and joint ventures at **fair value through profit or loss in accordance with IFRS 9**.

It is our understanding from paragraphs BC24 - BC25 that the IASB does not intend the information required by IFRS 12 (e.g. summarised financial information) to be disclosed for investments of an investment entity in controlled investees, associates and joint ventures. We agree with this approach. We think, however, that this should be clarified in the guidance. To achieve this, we think that the IASB should consider adjusting

- the current guidance in IFRS 12.6 (d) which requires IFRS 12 disclosures for the investments in associates and joint ventures measured at fair value through profit or loss, and
- the scope paragraphs in IFRS 7 and IFRS 12 which currently refer to the accounting and not the measurement in accordance with IFRS 9.

In paragraphs BC22 and BC23 the IASB proposes information that should be disclosed (i.e. disclosures about any explicit or implicit financial support that has been provided to entities it controls and about the nature and extent of significant restrictions with respect to the investee). Currently the respective disclosures are not addressed in this [draft] IFRS. In the event that controlled investees of an investment entity are not included in the scope of IFRS 12 (see above), we recommend that the IASB reconsiders whether these disclosures should be added in this [draft] IFRS.

We encourage the IASB to use its planned outreach activities to confirm whether the proposed guidance will lead to disclosures that will provide decision-useful information to the users of investment entities' financial statements.



**Question 9:**

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

9(a)

We agree that IAS 28 should be amended to require investment entities to measure their investments in associates and joint ventures at fair value through profit or loss in accordance with IFRS 9.

However, we strongly disagree with removing the measurement exception currently included in IAS 28 for venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds.

The IASB also acknowledges in BC28 that it "observed that the criteria developed in the exposure draft and the list of entities currently referred to in IAS 28 (as amended in 2011) have the same objective - to identify those entities for which fair value measurement of their investments provides more relevant information". However, due to the narrow definition of an investment entity proposed in this [draft] IFRS, we believe that many entities that currently use the measurement exception in IAS 28 may not qualify as investment entities. Therefore, these entities would be required to change their accounting, which the IASB acknowledges in BC29. We find this inconsistent with the IASB's belief that the fair value measurement basis provides more useful and relevant information. Consequently, we recommend that the existing measurement exception - which is widely used and well perceived by the users/stakeholders - should not be amended.

9(b)

As explained above we agree with this alternative and we recommend that the IASB strongly consider it.



a fair value measurement of such assets may also generate more decision-useful information.

We understand that this [draft] IFRS is intended to provide an exception for investment entities to consolidate controlled investees in accordance with IFRS 10. However, we recommend that the IASB considers including measurement guidance in this [draft] IFRS (or a reference to the measurement guidance in other IFRSs) for investments held by investment entities other than real estate and investments in controlled investees, associates and joint ventures. To this end, the IASB may consider the guidance in the FASB's proposed ASU, section 946-325 *Financial Services - Investment Companies - Investments - Other*.

- **Type of instruments issued to the investors of the entity:**

Paragraph 2(c) seems only to cover equity instruments. However in practice, highly leveraged funds exist where investors hold debt instruments issued by the funds, and not equity instruments. It is not clear why these types of funds would be excluded from the scope of this [draft] IFRS solely because its pooled funds are classified as liabilities rather than equity. We recommend the IASB consider investor's views on the appropriate financial reporting where a class of entities may be excluded based solely on the classification of their issued interests.

In summary, we recommend that the IASB consider clarifying the scope of the [draft] IFRS.

## 2. Unrelated investors:

With respect to the term "unrelated" we would like to draw the attention of the IASB to the following situation which is common in the insurance sector: certain insurance companies will set up an entity/fund to invest policyholder premiums on the policyholders' behalf. The entity/fund is the legal owner of the investments. The entity/fund passes the returns from the investments on to the policyholders through the insurance policies they hold, after subtracting an agreed fund management fee.

The policyholders in this case could be seen as having an 'indirect' investment in the entity/fund through the insurance policies they hold. Where the entity/fund meets all the other criteria to qualify as an investment entity, could such an entity be said to meet the 'unrelated investor' requirement as well?

Therefore, we recommend that the IASB considers if and under which circumstances indirect interests of others in entities could be regarded as unrelated investors for the purposes of qualifying as an investment entity.

In some jurisdictions, separate financial statements provide the basis for taxation and dividend payments. We therefore have concerns that the mandatory requirement to account for the investments at fair value through profit or loss in the separate financial statements may have unintended consequences.

We recommend that the IASB does not change the current measurement guidance for separate financial statements in IAS 27.

**5. Hierarchy between business purpose and business activities:**

We think it would be helpful for the IASB to clarify the hierarchy of assessing the explicitly stated business purpose versus the actual business activities of the entity. Consider the following - if an entity undertakes investment activities but does not explicitly state investing as its business purpose, would that entity still meet this criterion?

**6. Illustrative examples:**

Generally, we would recommend that the conclusion/analysis should cross-reference to the paragraphs applied to reach the conclusions.

**7. Paragraph B3:**

The IASB may consider excluding from this guidance collaterals received which also qualify as investments according to the nature of the investment activities and business purpose of the (investment) entity (e.g. when collateral represent shares in another entity).

**8. Paragraph B9:**

In sentence three the reference to 'majority interest' should be 'controlling interest'.