Deloitte.

IFRS Global Office
Issue 2, February 2012

IFRS industry insights

Financial services industry responds to IASB proposals on investment entities

The comment period for the ED closed in January 2012 and the IASB is expected to begin discussing constituent comments soon.

In August 2011, the International Accounting Standards Board ("IASB" or the "Board") issued exposure draft ED/2011/4 *Investment Entities* (the "ED") proposing that "investment entities" that meet specific criteria would account for investments they control at fair value through profit or loss rather than by applying the consolidation requirements of IFRS 10 *Consolidated Financial Statements*. The comment period for the ED closed in January 2012 and the IASB is expected to begin discussing constituent comments soon. This publication summarises the views of various constituents from the financial services industry on certain key areas of the IASB's proposals and indicates areas the Board is likely to focus on during their re-deliberations.

The ED would require all the following criteria to be met for an entity to be considered an investment entity:

- the entity's only substantive activities are investing in multiple investments for capital appreciation, investment income, or both;
- the entity makes an explicit commitment to its investors that the purpose of the entity is investing to earn capital appreciation, investment income, or both;
- ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed;
- the funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent and in aggregate hold a significant ownership interest in the entity;
- substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis; and
- the entity provides financial information about its investment activities to investors. The entity can be, but does not need to be a legal entity.

The ED proposes that an investment entity could provide services, or control an entity that provides services, related to their own investment activities. However, if an entity were to provide "significant" services related to another entity's investing activities, then the entity would not be considered an investment entity.

The ED also proposes that the fair value exception would not be retained by non-investment entity parents who consolidate investment entities. A non-investment entity parent of an investment entity would consolidate all entities it controls, including those controlled through the investment entity.

The proposals include an overall disclosure objective with application guidance. Additionally, the ED proposes to require disclosure of information about controlled investees. The ED also proposes prospective application.

Nearly all respondents from the financial services industry agreed that accounting for controlled investments at fair value through profit or loss rather than applying consolidation accounting provides more decision useful information to investors and users of financial statements.

Fair value as a basis for financial reporting

Nearly all respondents from the financial services industry agreed that accounting for controlled investments at fair value through profit or loss rather than applying consolidation accounting provides more decision useful information to investors and users of financial statements. Respondents noted that investors in investment entities focus on net asset value or other similar measurement attributes because such investors have a right to a proportional interest in the fair value of the net assets of the entity. These respondents also noted that measuring controlled investments at fair value would increase comparability with non-controlled investments which are currently carried at fair value and stated that the current lack of comparability distorts the financial performance of the entity. Some respondents asserted that providing consolidated financial statements provides little relevant information for financial statement users and are costly and burdensome to prepare.

However, financial services industry respondents were split on how best to identify investment entities where fair value should be the measurement basis. Traditional asset managers tended to support the IASB's proposed approach of requiring specific criteria, but raising specific concerns with certain of the proposed criteria. Industry trade groups and diversified financial institutions, on the other hand, were more evenly divided between supporting the IASB's proposed approach, using a more principles-based approach and focusing on the investing activities of the entity.

Some industry respondents suggested the exception to consolidation be driven based on management's intent and the entity's business model; concepts that are used in IFRS 9 *Financial Instruments*. Some respondents felt that if an investment is held for capital appreciation, investment income or both rather than for strategic purposes and is managed on a fair value basis then it would be appropriate to measure the investment at fair value regardless of the nature of the entity holding the investment. One respondent referenced current Japanese GAAP which includes a "venture capital clause" permitting non-consolidation of investee companies that meet specific criteria. Others suggested providing a choice to carry controlling interests at fair value rather than applying consolidation; one respondent suggested an irrevocable option applied to all investments while another suggested that the option be available on an investment by investment basis so that investment entities that are part of a larger group could carry their investments at fair value while other segments who hold strategic investments could apply consolidation accounting.

Investment entity criteria

As mentioned above, financial services industry respondents had differing views on the investment entity criteria proposed by the IASB. Areas of common concern on the proposed criteria included the requirement to hold multiple investments, the "pooling of funds" requirement, the "unit ownership" requirement and the managed on a fair value basis requirement.

For the proposal that an investment entity hold multiple investments, the concern was raised that a separate entity may be created to invest in a single investment. Several respondents did not understand why holding only a single investment should change the purpose of holding the investment for capital appreciation, investment income, or both.

Many respondents had concerns with the pooling of funds requirement emphasising that investment entities may be established on behalf of a single investor (e.g., a pension scheme or sovereign wealth fund). Some respondents also mentioned that all investors of certain investment funds' may be employees of the investment entity and therefore have no outside investors even though the fund will invest alongside another legal entity that contains investments from outside investors. Certain respondents also cited a lack of clarity on what would constitute a "significant ownership interest" that must be held by third party investors. Similar to comments made on holding multiple investments, several respondents noted that the investment objective of the entity does not change based on whether an entity has a single or multiple investors; it remained focused on capital appreciation, investment income or both.

The concerns or questions over the "unit of ownership" requirement primarily focused around whether collateralised debt obligations ("CDOs") or other similar structures would qualify as investment entities. CDOs do not have true form "equity" instruments but rather a class of subordinated debt instruments which receive residual cash flows. Other investment structures may have "equity" shares classified as liabilities under IAS 32 (e.g., mandatorily redeemable shares of a finite-lived fund). Respondents questioned whether these types of structures would meet the unit of ownership criteria.

On the managed on a fair value basis requirement, the concerns primarily focused on entities holding debt instruments with an investment objective of seeking yield through holding to maturity and therefore managed on an amortised cost basis rather than a fair value basis. Concerns on this specific issue were also raised around the business purpose criterion because many respondents did not believe it was clear whether holding fixed lived investments until maturity was an acceptable exit strategy.

There was overwhelming consensus that the fair value accounting of an investment entity should be retained in the accounting by its parent.

Industry trade groups, asset managers and diversified financial institutions raised concerns with the criteria being too narrow such that entities currently considered investment entities may not meet the definition under the proposed requirements. Concern was also expressed about the application of the criteria to entities in diversified financial institutions because other business activities would preclude "investment entity" divisions or segments from applying fair value accounting.

They suggested a business model approach similar to IFRS 9 so that a diversified group may have multiple business models with certain controlled investments for strategic purposes applying consolidation accounting while other controlled investments for capital appreciation or investment income applying fair value accounting.

Two asset managers suggested similar approaches of utilising the criteria "nature of the investment" and the "business purpose" as requirements and then overlaying the other criteria as considerations in support of an overall qualitative assessment. Similarly, another asset manager requested the Board use a principles-based qualitative approach to the criteria rather than a "checklist" approach and analogised to the principal/agent guidance contained in IFRS 10 that permits weighting of the various factors based on specific facts and circumstances.

Other activities of investment entities

Those respondents that commented on whether investment entities should be able to provide investment related services in addition to their investing related activities generally agreed that an investment entity should also be able to provide investment related services as part of its own investing activities without losing the investment entity designation. Many also supported consolidation by an investment entity of a controlled entity that provides investment related services as these entities are held for strategic reasons rather than for investment purposes. The issue of providing investment related services for other entity's investing activities is where the views began to differ. Whilst a few respondents agreed with the IASB's proposal, several respondents indicated that providing investment related services supporting another party's investment activities should have no bearing on whether the entity is an investment entity. A few respondents reiterated their view that the focus of the investment entity criteria should be on the basis of the business model and investing activities rather than on the basis of the nature of the entity.

Accounting by non-investment entity parent

Almost all industry respondents strongly opposed the IASB's proposal related to the accounting for controlled investees by non-investment entity parent entities. There was overwhelming consensus that the fair value accounting of an investment entity should be retained in the accounting by its parent. Many respondents felt that the IASB was being inconsistent in asserting that fair value information provided more decision useful information to investors of investment entities but not to investors of the group. Respondents also cited an inconsistency with the proposal that a parent of an investment entity would retain the fair value accounting applied by the investment entity to investments in associates and joint ventures and other non-controlled entities. The Basis for Conclusions of the ED states that "the boards expected that in most cases, investment entities would have investment entity parents." Several respondents raised issue with this statement noting that both asset managers and diversified financial institutions frequently include investment entity subsidiaries within their consolidated group.

Several respondents accept the Board's concern about potential abuse and structuring opportunities. However, many felt that appropriately establishing the investment entity criteria would address the Board's concerns. Some respondents indicated that a principles-based criteria focusing on the business model of the entity would limit the ability for structuring whereas rules-based criteria based on the nature of the entity was more susceptible to structuring opportunities. Additionally, some respondents suggested that robust financial statement disclosure may help to mitigate the potential for abuse.

Many respondents noted the U.S. Financial Accounting Standards Board ("FASB") has issued similar proposals on investment entities, but the FASB's proposals would permit retention of fair value accounting at the parent level. They emphasised the importance of convergence in this area and requested the IASB to consider the FASB's proposals regarding parent accounting. Several respondents also noted that current U.S. GAAP requires the parent's retention of fair value accounting for consolidated investment companies which has not been a source of abuse.

Implications for associates and joint ventures

The ED proposes to amend IAS 28 *Investments in Associates and Joint Ventures* to require investment entities to measure its investments in associates and joint ventures at fair value through profit or loss. As part of these amendments, IAS 28 would replace the existing guidance referencing "venture capital organisations, mutual funds, unit trusts and similar entities" with "investment entity". These amendments may result in some entities that currently apply the fair value election for their investments no longer being eligible for fair value accounting because they don't meet the definition of an investment entity.

Many respondents agreed with the ED including a proposed disclosure objective rather than requiring specific, detailed disclosure requirements for investment entities.

Most industry respondents opposed these proposals because of their affect on certain entities that currently apply fair value accounting. Examples of entities that may not qualify under the investment entity criteria but use the fair value election in IAS 28 include venture capital organisations and various insurance related entities. Respondents reiterated their view that fair value information provides more decision useful information for these types of entities and also questioned why the IASB would want more entities to apply the equity method accounting given that type of accounting is frequently criticised by constituents. Many respondents support the alternative included in the IASB's ED that would require use of fair value accounting for associates and joint ventures by investment entities but still permit an election for those other entities who currently qualify for fair value accounting under IAS 28.

Disclosures

Many respondents agreed with the ED including a proposed disclosure objective rather than requiring specific, detailed disclosure requirements for investment entities. However, a few respondents had concerns with the level of detail of the example disclosures included in the ED. Some respondents expressed concern that in addition to the disclosures for investments entities, they would also be required to disclose information under IFRS 7 *Financial Instruments: Disclosures,* IFRS 12 *Disclosure of Interests in Other Entities* and IFRS 13 *Fair Value Measurements*. One industry trade group raised concerns with the proposal to provide specific information on controlled investees because disclosing this information may be competitively detrimental. However, an asset manager suggested this information be provided for all investees whether controlled or not by analogising to the schedule of investments required under U.S. GAAP.

Transition

Views were mixed on the IASB's proposals that would require prospective application. Most respondents were generally supportive of prospective application because of its simplicity. However, many respondents requested that the Board also permit retrospective application if entities choose to do so. These respondents believe that historical fair value information would be readily available and would not be overly burdensome to apply retrospectively. Some respondents also expressed concern with the differing transition approaches between IFRS 10 (modified retrospective) and the ED (prospective) as the ED is viewed as an amendment to IFRS 10.

Next Steps

The Boards are hosting roundtables with constituents and will consider the feedback received during all of their outreach activities. The Boards are expected to begin re-deliberating the proposals in the next few months.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.co.uk/about for a detailed description of the legal structure of DTTL and its member firms.

Deloitte LLP is the United Kingdom member firm of DTTL.

This publication has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication. Deloitte LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

© 2012 Deloitte LLP. All rights reserved.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 17013A

Member of Deloitte Touche Tohmatsu Limited