

Accounting Standards Board of Japan (ASBJ)

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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir or Madame,

Comments on the Exposure Draft **“Investment Entities”**

We appreciate the continuous efforts made by the International Accounting Standards Board (IASB) to improve the accounting requirements for consolidation and welcome the opportunity to express our comments on the Exposure Draft “Investment Entities” (hereinafter referred to as “the ED”).

1. General Comments

1. We highly appreciate the efforts made by the IASB and the US Financial Accounting Standards Board (FASB) to develop a common approach with regard to the investment entities in order to address concerns and needs raised by many constituents during the process of developing IFRS 10 *Consolidated Financial Statements* (hereinafter referred to as “IFRS 10”).

(Comments on proposed accounting for investment entities)

2. We generally support the idea underlying the proposals in the ED that there is a situation where measuring the investments at fair value through profit or loss could provide more useful information to users rather than consolidating the investees even if it controls the investees.
3. We understand that in many circumstances, presenting information with regard to assets and liabilities of an investee in the consolidated financial statements would provide useful information to users if the reporting entity controls the investee. However, as commented by many respondents during the process of developing IFRS 10, we believe that in some circumstances, measuring the investment at fair value would better meet the information needs of users than consolidating the investee.

4. However, we are concerned that the proposal in the ED seems to be rule-based because it focuses primarily on developing the criteria of the investment entity in view of limiting its scope. We believe that the ED does not sufficiently focus on in which circumstances the fair value measurement provides more decision-useful information as opposed to consolidation and that the proposal would not necessarily be understandable and consistently applicable for all constituents. Although it would be provided as an exception to the consolidation, we believe the IASB should clearly define fundamental concept or principle underlying the proposal and establish specific criteria based on that concept or principle.
5. In this regard, we are of the view that for the entity's investment in general the information to be provided should be defined according to the nature and characteristics of each investment. For example, when the changes in the value of the entity's investment directly represent performance of the entity's activities and the value can be reliably measured, it can be argued that providing information about the value and its changes to users of financial statements would be appropriate.
6. From that perspective, we are of the view that developing the principle such that when the entity hold its investment for the purpose of obtaining capital gains through appreciation of the investment and the investment meets both of the following characteristics, measuring the investment at fair value would be more useful than consolidating the investee.
 - (1) It is probable that the entity disposes its investments within a foreseeable period.
 - (2) The entity uses the fair value and its changes for evaluating the performance of the investment on a regular basis.
7. The characteristic in paragraph 6 (1) would ensure that the nature of investment is to obtain capital gains and the characteristic in paragraph 6 (2) would ensure that the fair value can be reliably measured as well as the nature of investment. We believe that having both characteristics would provide the fair value information that is likely to close to the ultimate cash inflows to the entity.
8. As mentioned above, we believe that the measurement basis of investments should be determined based on their natures and characteristics. We do not consider that the ED's approach of setting criteria for that determination on the entity basis is always necessary. However, given that some types of funds (such as mutual funds) trade many investments frequently, we can accept the use of the entity-based approach as a means to limit the scope of the proposal, assuming that the specific criteria are established in a consistent manner with the principle we suggested in paragraph 6.

- 9. The relationship between the criteria proposed in the ED and our principle we suggested in paragraph 6 above is that the nature of investment (that is, obtaining capital gains) and the characteristic in paragraph 6 (1) would be consistent with the nature of investment activity criterion and business purpose criterion that includes the existence of an exit strategy, and the characteristic in paragraph 6 (2) would be consistent with the fair value management criterion. We believe that these criteria need further clarification and tightening (For details, refer to paragraph 16 and 17)..
- 10. On the other hand, we are of the view that the criteria of unit ownership and pooling of fund in the ED are complementary ones to prevent potential abuse. From the perspective of the principle we suggested in paragraph 6, these criteria would not necessarily be essential. Therefore, we recommend that the IASB should reconsider their necessity and the possibility of the alternatives.

(Comments on proposed accounting by a non-investment entity parent)

- 11. We disagree with the proposal that the non-investment entity parent never be allowed to retain the accounting of the investment entity subsidiary in the consolidated financial statements. In our view, even if the criteria would be developed on a entity basis, investments should be measured at fair value if the parent holds the investments through its investment entity subsidiary in a consistent manner with our principle in paragraph 6, because to so do would be useful to users of the financial statements of the parent. Concerns about potential accounting inconsistencies and possibilities for abuse could be addressed by requiring judgments in light of the principle mentioned above and providing additional criterion in line with that principle, if necessary (Refer to Question 4 and 6).

2. Comments on specific questions

Our comments on questions set out in the ED are as follows:

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?

- 12. We agree that there is a class of entities, commonly thought of as an investment entity in nature, that have the investments that should be measured at fair value through profit or loss rather than consolidation even if it controls the investee. However, in our view, in order to

make the proposal more understandable and consistently applicable, a fundamental concept or principle regarding in what circumstances the fair value measurement provides more decision-useful information than consolidation should be defined and then specific criteria should be established based on that concept or principle (For its reasons and our suggestions, refer to General Comments section above).

Question 2

Do you agree that that 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?

13. We have some concerns with the proposed criteria of the investment entity in the ED. Our main concern is that the proposals seem quite rule-based that are being developed without defining any fundamental concept or principle. As mentioned above, we believe that the IASB should clearly define the fundamental concept or principle underlying the proposal and establish specific criteria based on that concept or principle.
14. In this regard, the principle we suggested in paragraph 6 would lead to the essential criteria such as investment activities for capital appreciation, the existence of an explicit exit strategies, and fair value management. On the other hand, the proposed criteria of unit ownership and pooling of funds would not be considered as essential in terms of the principle and would be complementary ones to prevent potential abuse.
15. From this point of view, we believe that the IASB should clarify or enhance the essential criteria and reconsider the complementary criteria in terms of whether they are necessary and whether there are any alternatives based on the principle.

(Existence of an explicit exit strategy)
16. We believe that the existence of an exit strategy is highly important as a necessary condition to ensure that the entity holds the investment for capital appreciation and it is probable that the entity disposes the investment. While we recognize that it is mentioned in the application guidance, we believe it should be more emphasized in the standard as essential criteria. In order to ensure that it is probable that the disposal occurs within a foreseeable period, the IASB should tighten the criteria by, for example, requiring the entity to specify the timing or the range of timing at which it expects to exit the investment or to determine specific plan to ensure the practicability of the exit strategy depending on the nature of investment activities.

(Fair value management)

17. The ED describes the fair value management criterion as ‘Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis.’ However, we are concerned that the diversity in applying the criterion might arise because it is not always clear how and to what extent the entity needs to ‘manage’ and ‘evaluate’ the investment on a fair value basis. Therefore, we believe that this criterion should be clarified, for instance, by requiring that the fair values of the investments are internally reported to key management personnel as primary financial information on a regular basis.

(Other criteria)

18. As mentioned above, we are of the view that the criteria of unit ownership and pooling of funds would be complementary ones and therefore the IASB should review the necessity of those and the possibility of any alternatives.
19. We understand that the pooling of fund criterion proposed in the ED represents a typical characteristic of an investment entity and it is a powerful criterion to prevent potential abuses (for example, the parent sets up an investment entity as its subsidiary and thereby excludes its ultimate investees from the consolidation).
20. However, we do not believe that it is appropriate that this criterion would preclude the entity from applying the fair value accounting for the investment in the situations where the fair value information would be more relevant to the users than consolidated information. We believe that this criterion is just a complementary one and concerns for potential abuses could be addressed in a different way. Therefore, we disagree with the proposal to require as a crucial criterion that the investment entity should have external investors who hold significant ownership interests in the entity.
21. We are of the view that the possibilities of abuse could be mitigated by requiring substantive judgments in light of the principle we suggested in paragraph 6 and resulting criteria. In addition, it could also be addressed by adding more direct criteria (for example, a criterion that the entity holding the investments should not be considered as merely receiving the transfer of the business from the reporting entity or conducting the business on the behalf of the reporting entity) (For other comments on this criterion, refer to our responses to Question 4).
22. Regarding the unit of ownership criterion, the reason for requiring it is not sufficiently clear in the ED and therefore its intention and necessity should be clarified.

- 23. In addition, the disclosure criterion in paragraph 2 (f) of the ED states that ‘the entity can be, but does not need to be, a legal entity’. We are of the view that this statement need not be treated as part of the criterion because it would not impose any condition.
- 24. The criterion in paragraph 2 (a) of the ED requires the entity to hold the ‘multiple investments’. Although we agree that an entity holding multiple investments would more likely to be an investment entity, it is not a necessary condition for the appropriateness of measuring the investment at fair value and it would be sufficient to treat this as an indicator.

Question 3

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

Why or why not?

- 25. We agree with the proposal that an entity should be eligible as an investment entity even if it provides the services that relate to its own investment activities. As far as the entity provides the service within the purpose of capital gains from the investments, the service can be viewed as aiming at fruits from liquidation of the investments (realization of capital appreciation) rather than the fruits of the service itself. Therefore, we believe it would not prevent the appropriateness of measuring the investment at fair value.

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.

- 26. As mentioned in our response to question 2, in the situation where we think the fair value information would be more useful than consolidated information (see paragraph 6), we believe that whether there are multiple investors or whether there are external investors having significant ownership interests in the entity would not necessarily be relevant. Therefore, we believe that measuring the investments at fair value should not be prohibited even if the entity has a single investor.

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 IFRS9 and IAS39 *Financial Instruments: Recognition and Measurement*? Why or why not?

27. We are of the view that applying the fair value model to investment properties would provide more appropriate information than applying the cost model as far as investment entities hold investment properties meeting the criteria derived from the principle we suggested in paragraph 6. Therefore, only under such circumstances, we support the proposal to apply the fair value model in IAS 40.

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?

28. We do not agree with the ED's proposal to require the non-investment entity parent of an investment entity to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities. Provided that the non-investment entity parent holds the investments through the investment entity subsidiary in a consistent manner with the principle we suggested in paragraph 6, we believe that the fair values of such investments would also be useful for users of financial statements of the parent. Therefore, we believe that measuring those investments at fair value in the consolidated financial statements of the parent would be appropriate.
29. We understand concerns about potential accounting inconsistencies and possibilities for abuse as indicated in the ED. However, we are of the view that these concerns could be addressed by requiring that the parents should hold the investments in a consistent manner with the principle we suggested in paragraph 6 in addition to the refined criteria at investment entity level (including an alternative to the pooling of fund criterion as described in paragraph 21).

Question 7

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

30. We agree with the use of the disclosure objective proposed in paragraph 9 of the ED. We believe, however, that from our viewpoint that measuring the investment at the fair value through profit or loss would be more appropriate for a certain investment than consolidating the investees, the IASB should identify necessary disclosure related to the proposal and prescribe them as disclosure requirements specific to this proposal like the items in paragraph 10 (a) to (d) or B18 in the ED rather than simply requiring the entity to apply the disclosure requirements under IFRS 12.

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?

31. We agree with applying the proposals prospectively because it is consistent with the transitional provision in IFRS 10, although retrospective application would generally be preferable in view of comparability.

Question 9

- (a) Do you agree that IAS28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft?
- (b) As an alternative, would you agree with an amendment to IAS28 that would make the measurement exemption 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?

32. As stated above, we believe that the criteria of the investment entity in the ED should be refined based on the principle we suggested in paragraph 6. Provided that the entity holds the investment in accordance with the refined criteria, we consider that the information provided by measuring the investment at fair value would be more useful than by applying the equity method. Therefore, under such circumstances, we support that the IAS 28 should also be amended so that the mandatory measurement exemption would apply only to the investment entity.

33. We basically disagree with the alternative in (b) above because it would result in providing an unlimited choice. However, considering that the proposal might occur unintended consequence to existing IFRS applicants, we believe that the IASB should review its effect deliberately during the redeliberations.

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We hope our comments will contribute to the forthcoming deliberations in the project.

Yours sincerely,

Handwritten signature of Takehiro Arai in cursive script.

Takehiro Arai Chairman of the Consolidation/SPEs Technical Committee
Vice Chairman of the Accounting Standards Board of Japan