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Comment on Exposure Draft Investment Entities: Applying the Consolidation Exception, *Proposed Amendments to IFRS 10 and IAS 28*

General comments

1. The Accounting Standards Board of Japan ("ASBJ" or "we") welcomes the opportunity to provide comments on the International Accounting Standards Board ("IASB")'s Exposure Draft, *Investment Entities: Applying the Consolidation Exception, Proposed Amendments to IFRS 10 and IAS 28* (hereinafter referred to as "the ED").

2. The ASBJ agrees with the IASB's proposal relating to Questions 1 in the ED which is to confirm the applicability of paragraph 4 (a) of IFRS 10 *Consolidated Financial Statements*. However, the ASBJ disagrees with the proposals relating to Questions 2 and 3 of the ED.

Comments on Question 2

3. Question 2 of the ED proposes to clarify that the requirement for an investment entity to consolidate its subsidiary (instead of measuring at the investment fair value) applies *only* to the subsidiary that acts as an extension of the operation of the investment entity parent and does not itself qualify as an investment entity. This would mean that when an investment entity parent holds an investment in an investment entity subsidiary that provides services to third party entities, the parent would be required to measure the investment in the investment entity subsidiary at fair value through profit or loss (FV-PL).

4. The ASBJ disagrees with this proposal. The ASBJ believes that when an investment entity parent holds an investment in an investment entity subsidiary, the parent should measure its investees held by the investment entity subsidiary at FV-PL and consolidate the financial statement of the subsidiary in its consolidated financial statement, regardless of whether the subsidiary provides

investment-related services to third party entities. By doing so, the ASBJ believes that the consolidated financial statement of an investment entity parent would faithfully represent the different nature of activities undertaken by the investment entity subsidiary, and would provide useful information to users.

Comments on Question 3

5. Question 3 of the ED proposes that different accounting treatments be used for a non-investment entity investor when applying the equity method to its investees meeting the definition of an investment entity, based on whether the investee is an associate or a joint venture. The ASBJ disagrees with this proposal. The ASBJ is of the view that a non-investment entity investor should retain the fair value measurement of its investments held by investment entities in the consolidated financial statements, regardless of whether these investees are associates, joint ventures or subsidiaries. By doing so, the ASBJ believes that the consolidated financial statements of the non-investment entity investor would provide useful information to users. For details, please refer to the comment letter to the IASB's ED *Investment Entities*[1] published in August 2011.

Other comments

6. As stated in our comment letter to the IASB's ED published in August 2011, the ASBJ continues to believe that a non-investment entity parent should retain the accounting of its investment entity subsidiary in the consolidated financial statement. By doing so, the ASBJ believes that the consolidated financial statement would faithfully represent the nature of the investments held by the investment entity subsidiary.

7. In addition, the ASBJ notes that the IASB is required to conduct a post-implementation review in accordance with the requirement of the Due Process Handbook when it develops a new Standard or has made major amendments to a Standard. Following the requirement, the ASBJ presumes that a post-implementation review of IFRS 10 *Consolidated Financial Statements* will be carried out in the future. Having regard to the conflicting views leading up to the amendment of IFRS 10, the ASBJ encourages the IASB in the course of the review, to give particular focus as to whether the prohibition of retaining the accounting treatment of an investment entity subsidiary resulted in useful information for users.

8. For our comments on specific questions in the ED, please refer to the Appendix to this letter. The ASBJ hopes that our comments will be helpful for the IASB's

[1] https://www.asb.or.jp/asb/asb_e/international_activities/comments/20120105_e.pdf

future deliberations. If you have any questions, please feel free to contact us.

Yours sincerely

Take Arai

Takehiro Arai

Vice-chairman of the Accounting Standards Board of Japan

Chairman of the Consolidation/SPEs Technical Commitee

Appendix

Comments on Specific Questions in the ED

Question 1—Exemption from preparing consolidated financial statements
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?

9. The ASBJ agrees with this proposal. The ASBJ understands that consolidated financial statement presented by an intermediate parent that is a subsidiary of an investment entity has some potential to provide useful information to financial statement users. However, if the intermediate parent meets all the criteria listed in paragraphs 4(a) (i) - (iii) of IFRS 10, there is a presumption that capital providers (existing and potential investors, lenders and other creditors) to the subsidiary are quite limited and the investment entity parent and other non-controlling owners do not object to the intermediate parent not presenting consolidated financial statement. Therefore, the information needs of users of the consolidated financial statement of the intermediate parent are considered to be relatively low.

10. In addition, as stated in paragraph BC4 of the ED, the information needs of financial statement users of an intermediate parent (which is a subsidiary of a higher level parent) would be in part addressed by the information available in the consolidated financial statement of the higher level parent as well as the separate financial statement of the intermediate parent entity.

11. Accordingly, in light of the cost-benefit balance, the ASBJ supports the proposed amendment in the ED that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 is applicable for an intermediate parent 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.

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?

12. The ASBJ disagrees with this proposal. While permitting certain exceptions, the existing IFRS 10 generally requires that an investment entity parent's investment in an investment entity subsidiary should be measured at FV-PL. The ASBJ understands the IASB's views and rational in reaching its conclusion. However, for the reasons stated in paragraph 13 to paragraph 17 of this letter, when an investment entity parent holds an investment in an investment entity subsidiary, the ASBJ believes that, except for certain cases, the parent should measure the investees held by the investment entity subsidiary at FV-PL and consolidate the financial statement of the subsidiary in its consolidated financial statement (rather than measuring the investment entity subsidiary itself at FV-PL), irrespective of whether the subsidiary provides investment-related services to third party entities.

13. This is because the ASBJ believes that a measurement basis of an investment in an asset should be determined based on the nature or characteristics of each investment. Therefore, for an investment in which a change in the value of the investment itself is supposed to represent the performance of an entity's activities and its value can be reliably measured, the ASBJ believes it is appropriate to select a measurement basis that would faithfully represent the value and the changes in the value such that the resulting information would be useful to users of financial statements.

14. In this respect, by definition, investees of an investment entity generally have the characteristics of the investment described in the previous paragraph. However, if investees held by an investment entity meet both the definition of an investment entity and that of a subsidiary, the ASBJ does not believe that the investment entity subsidiary itself has the general characteristics of an investment in the context of the group's consolidated financial statements of the investment entity parent. This is because such a subsidiary generally conducts investment activities in accordance with the same or similar business purpose as that of the investment entity parent, and the investment in the investment entity subsidiary itself would not be held for the purpose of capital appreciation in the context of the group's entire activities.

15. For these reasons, the ASBJ believes that, in principle, measuring the investees held by the investment entity subsidiary at FV-PL and consolidating the financial statements of the subsidiary would more faithfully represent different nature of

activities in the group's consolidated financial statements of the investment entity parent.

16. In addition, even when both the investment entity parent and the investment entity subsidiary conduct the same investment related activities, following the proposal in the ED would result in the presentation of different information on the face of the consolidated financial statement.

17. Furthermore, if an entity were required to measure an investment in an investment entity subsidiary that provides investment-related service at fair value, an entity would be required to go through quite a complicated process (including the use of valuation technique) to determine the fair value, unless the fair value of such an investment is observable in the market. In that case, there is a view that the valuation process may result in an entity incurring significant costs. Therefore, the ASBJ thinks that the cost of measuring the investment would not necessarily be smaller than the cost of making the adjustments necessary to ensure the uniform accounting policies and the uniform reporting period-ends between the parent and its investment entity subsidiary.

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?

18. The ASBJ disagrees with this proposal, because we do not support the amendment proposed in paragraph (b) of this question. The ASBJ believes that introducing different accounting requirements to investments held by an associate or a joint venture is inappropriate, and a non-investment entity investor should retain the fair value measurement of its associate or joint venture, regardless of whether they are held by an investment entity associate or a joint venture, for the reasons stated in

the following paragraphs.

Usefulness of a Non-Investment Entity Investor's Consolidated Financial Statement

19. By definition, an investment entity is supposed to hold its investments for the sole purpose of capital appreciation, investment income or both, and measure and evaluate the performance of substantially all of investments on a fair value basis, regardless of whether these investments are controlling interests or non-controlling interests.

20. As stated in paragraph 13 of this letter, the ASBJ believes that the measurement basis of an investment should be determined based on the nature or characteristics of each investment. If an investee held by a non-investment entity investor meets the definition of an investment entity, the ASBJ believes that retaining the investee's fair value measurement to its investees would enable the investment entity investor to measure its ultimate investments consistent with the nature or characteristics of each investment in the consolidated financial statements of the non-investment entity investor, regardless of whether the investee is a subsidiary, an associate or a joint venture.

21. Accordingly, if FV-PL measurement of an investment subsidiary, associate or joint venture is supposed to provide useful information in its financial statement, the ASBJ believes it is appropriate to retain that measurement in the investor's consolidated financial statement, unless determined otherwise in light of the investor's consolidated financial statement.

22. Meanwhile, IAS 28 *Investments in Associates and Joint Ventures* permits an entity to measure its investment in the entity at FV-PL, if it indirectly holds an investment in an associate or a joint venture such as through a venture capital organisation. This is because that FV-PL measurement would provide more useful information for users of the consolidated financial statements of the investor that invests in an associate or a joint venture than through the application of the equity method (see paragraph BC12 of IAS 28).

23. The ASBJ believes that the measurement basis of assets should be determined based on the nature of investments in the context of consolidated financial statements, and the FV-PL measurement should be applied to the investments to which measurement at FV-PL is found to be relevant. Therefore, if FV-PL measurement of investees using the fair value option in IAS 28 is supposed to provide more useful information to users of the consolidated financial statements than would be provided through the application of the equity method, consistent

with our views stated in paragraph 21 of this letter, the ASBJ believes that retaining the FV-PL measurement in the consolidated financial statements of a non-investment entity investor provides useful information to users.

Needs of Consistent Application of the Equity Method of Accounting and Risk of Lowering Understandability

24. Paragraph BC41 of IFRS 11 *Joint Arrangements* explains that the IASB concluded that the equity method is the most appropriate method to account for joint ventures, although the IASB acknowledged that the concept of “significant influence” (for associates) and that of “joint control” (for joint ventures) are different.

25. In this regard, there is a view that different accounting treatments may be justified in the application of the equity method depending on whether the investment is in an associate or a joint venture, reflecting the differing nature of the investment held by an investor. The proposal in the ED would be consistent with this view, because it requires different accounting treatments to be applied to an investment in an associate and to that in a joint venture.

26. However, an investment in an associate and an investment in a joint venture are common in that both have a share in the net assets of the investee. Thus, the ASBJ believes that it is inappropriate to differentiate between accounting requirements in the context of the equity method of accounting, depending on whether an investment is made in an investment entity associate or joint venture. Instead, the ASBJ thinks that FV-PL measurement by an associate or a joint venture should be reflected in its investor’s consolidated financial statement in line with the basic thinking stated in paragraph 13 of this letter.

27. In addition, if the IASB were to require different accounting treatments be applied to an investment in an associate or a joint venture to which the equity method of accounting is applied, the resulting accounting treatments would be very different, although the significant accounting policy only describes the fact that the equity method of accounting is applied to both investments. The ASBJ believes that requiring different accounting treatments applied to an investment in an associate and to that in a joint venture would hinder users understanding of the consolidated financial statement except when users are supposed to be those who have a very sophisticated knowledge of accounting

28. Additionally, the ASBJ found the proposal of the ED is unclear as to how a non-investment entity investor should account in its consolidated financial statement, where the investor holds an investment in an associate or joint venture,

and the associate or joint venture holds an investment in its associate or joint venture. Accordingly, the ASBJ recommends that the IASB clarify the effect in the course of the amendments.

29. Furthermore, paragraph BC21 of the ED refers to structuring risks using an investment entity joint venture. However, as stated in paragraph 20 of this letter, if measuring the investments at FV-PL is supposed to provide useful information in the financial statements of an investment subsidiary, associate or joint venture, it would also be generally appropriate to measure such investments at FV-PL in the consolidated financial statement of the investor. At the same time, structuring risks could be addressed by modifying the definition of an investment entity or by requiring an investor to double-check if faithful representation of the nature or characteristics of its investments are impeded from the perspective of the consolidated financial statements of the investor.

30. Moreover, by definition, a single joint venturer is not supposed to control the joint venture, and the gross amount of assets or liabilities would not be presented in the statement of the financial position as a result of the equity method of accounting. Therefore, the ASBJ thinks that the structuring risks designed to hide a higher leverage through the use of an investment entity joint venture (as illustrated in paragraph BC280 of IFRS 10) would be relatively low.

Others

31. Paragraph BC19 of the ED explains that consolidating financial statements of subsidiaries of an investment entity associate or joint venture into the financial statements of the parent prior to the application of the equity method of accounting is conceptually consistent with the provisions in IFRS 10, which requires a non-investment entity parent to consolidate subsidiaries held through such investment entity subsidiaries.

32. Historically, the equity method of accounting is said to have been derived from the consolidation process, and it has been referred to as “one-line consolidation.” However, the extent to which the equity method of accounting should be consistent with the principles in IFRS 10 is not necessarily clear under the existing requirements of IFRSs, in part due to the difference between the notion of “control” and that of “significant influence.”

33. Accordingly, the ASBJ does not believe that it is always appropriate to determine the accounting requirements of the equity method of accounting, just for the sake of consistency of accounting requirements with IFRS 10. Before determining

whether such rationale is appropriate, the ASBJ believes that further research should be conducted to better understand the conceptual basis of the equity method of accounting. Having recognised a number of other issues relating to the equity method of accounting, the ASBJ recommends the IASB to carry out the research project expediently.