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**Sent electronically through the IASB Website ([www.ifrs.org](http://www.ifrs.org))**

10 January 2012

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

Dear Sirs,

**[IASB Exposure Draft of Investment Entities](#)**

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft. Our responses to the questions raised in your Exposure Draft are set out in the Appendix for your consideration.

We welcome the Board's proposals to amend IFRS 10 *Consolidated Financial Statements* in relation to consolidation requirements for investment entities. The proposals respond to the concerns of constituents who expressed support for a consolidation exception for investment funds in comment letters during the development of IFRS 10.

Overall, we agree with the Board's proposal for an exception to the consolidation principle on the basis that for investment entities, the fair value measurement attribute is the most relevant information to users of financial statements because the investments are for capital appreciation, investment income or both, but are not for the purposes of integrating into the operations of the group at large. While we agree that criteria should be set to determine whether this consolidation exemption should be applied to an entity, we are concerned that the proposed wording in paragraph 2 can be applied to many situations which in our view do not reflect the Board's intention. Hence we believe that the drafting of this paragraph requires considerable reconsideration to ensure it only captures those entities intended to be captured. In this regard, we recommend that a more principles-based approach is adopted, with an investment entity being defined as a venture capital organization, mutual fund, unit trust or similar entity, including investment-linked insurance fund, whose principal business purpose is to invest in entities for capital appreciation of the investments, investment income (such as dividends or interest), or both. With such definition of an investment entity, criteria are then set out, such as those in paragraph 2 of the ED, to determine whether a reporting entity is an investment entity based upon this principle.

In addition, we have concerns with regards to the "multiple investments" criterion set out in paragraph 2(a) and "multiple investors" criterion set out in paragraph 2(d). We see no conceptual arguments to distinguish an investment entity that has a single investor or a single investment to the one that has multiple investors in qualifying as an investment entity. These concerns are expressed in more detail in our answer to question 2.



Moreover, we do not agree with the requirement that a parent, which is not an investment entity itself, should consolidate the controlled entities that it holds through subsidiaries that are investment entities. In our view, if application of the investment entity exception at the subsidiary level results in fair value information that is more decision-useful than consolidated information then we would expect such fair value information to be relevant in the financial statements of the ultimate parent entity. We understand that the FASB proposals preserve the accounting treatment in its parent's financial statements and we support convergence with US GAAP in this area.

If you have any questions on our comments, please do not hesitate to contact me at [ong@hki CPA.org.hk](mailto:ong@hki CPA.org.hk).

Yours faithfully,

Steve Ong, FCPA, FCA  
Director, Standard Setting Department

SO/WC/jn

Encl.



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

**Comments on IASB Exposure Draft of *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?**

We agree with the Board that there is a class of entities that should be exempted from consolidating its controlled entities. This is the case when the fair value measurement attribute is the most relevant information for financial statement users and the business model of the reporting entity is to invest for capital appreciation, investment income or both.

However, we have a number of concerns about the criteria set out in paragraph 2 of the ED (please see our response to Question 2 in details).

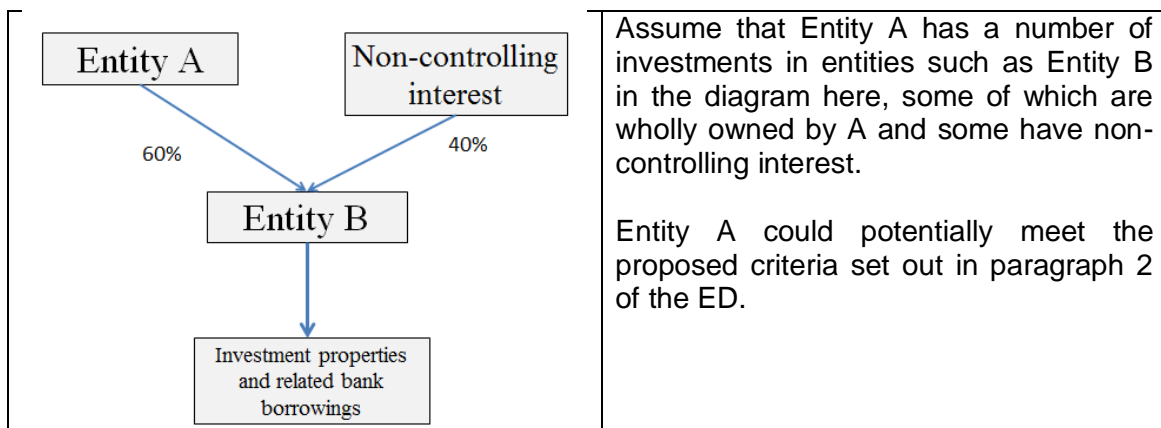
**Question 2**

**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?**

In general, we believe that consolidated financial statements provide the most useful form of financial reporting for most types of entities. Therefore, we agree with the Board that reporting entities have to meet certain criteria in order to qualify for the consolidation exemption.

However, we are concerned with the proposed wording set out in paragraph 2 of the ED.

We are concerned that the current wording could be applied to many more entities than the Board had intended. Below is an example that we believe is common in many jurisdictions for the ownership of an investment property (or, in fact, operating subsidiaries)





We do not believe that the consolidation exemption should be applied to all instances which fit into the above scenario. We believe that a more principles-based approach should be adopted, with an investment entity being defined as a venture capital organization, mutual fund, unit trust or similar entity, including investment-linked insurance fund, whose principal business purpose is to invest in entities for capital appreciation of the investments, investment income (such as dividends or interest), or both. With such definition of an investment entity, criteria are then set out, such as those in paragraph 2 of the ED, to determine whether a reporting entity is an investment entity based upon this principle. This proposal is consistent with the measurement exemption set out in IAS 28 *Investments in Associates and Joint Ventures*.

We also believe that for clarity, specific guidance should be added in the final Standard explaining that real estate investment trusts, companies or funds whose principal investment (or business) objective is to invest in real estate (or investment properties) for capital appreciation, investment income arising directly from net rentals, or both, do not qualify as investment entities. This is because such an entity generally holds the investment properties in a corporate wrapper, as opposed to owning it directly, for tax or structuring reasons, and based on the principle of an investment entity set out above, is not an entity "whose principal business purpose is to invest in entities for capital appreciation of the investments, investment income (such as dividends or interest), or both". Otherwise, we are concerned that large amounts of borrowings incurred by the property holding subsidiaries of entities such as Entity A in the above example will be removed from the statements of financial position of such entities. The leverage within such real estate investment trusts, companies or funds is important and useful information for investors in their decision making process.

We believe that all the criteria proposed in the ED are necessary in order to define an investment entity. However, we have the following comments on the criteria:

**Criterion 2(a)**

Paragraph 2(a) requires that an investment entity must hold multiple investments. However, it is not uncommon for investors as part of a broader investment strategy to invest in a fund such as a side pocket or an overflow fund that holds a single investment. Typically, the side pocket or overflow fund, which holds one asset, is invested in concurrence by common investors to a separate main investment. The single investment fund would meet all of the criteria of an investment entity with the exception of having multiple investments. Given the nature and explicit business purpose of a single asset investment entity is the same as an entity that invests in multiple investments (i.e. to invest for capital appreciation, investment income, or both), we do not see any conceptual differences between a single investment entity and an entity that invests in multiple investments and we believe that the criteria should be amended to allow for this type of arrangement to be regarded as an investment entity.

In addition, we noted that, in practice investment entities may enter into economic hedging activities to hedge exposures arising from the investments (e.g. to enter into derivatives to hedge against certain downside risks of their investments). We do not believe that such hedging activities of themselves should result in the entities failing to meet criterion (a) as these activities are "related" to the investments and therefore we believe that criterion (a) should be amended to allow for such activities.



Similarly, in some situations, investment entities may have entered into short-term held-for-trading investments. Again, we do not believe that such activities should result in the entities not meeting criterion (a) and therefore we believe that criterion (a) should be amended to allow for such activities.

***Criterion 2(b)***

The criterion in paragraph 2(b) requires an entity to have and communicate its "business purpose". Paragraph B9 to B11 discuss an entity's business purpose, which includes an investment entity's exit strategy for how the entity plans to realize capital appreciation of its investments. However, there is no mention of an exit strategy in paragraph 2(b). Therefore, we recommend that this requirement be explicitly incorporated in paragraph 2(b) as an essential component of the investment entity's business purpose.

***Criterion 2(c)***

The criterion in 2(c) requires the claim of the unitholders to be proportionate, however the supporting paragraph B12 requires there to be a specifically identifiable portion of the net assets of the investment entity. We have seen many examples where investors can invest discriminately and not necessarily in all the investments held by the entity. We do not think that discriminate investment should prohibit the nature of the entity from being for investment purposes. The guidance in B12 requiring a specifically identifiable portion of net assets appears to capture the nature of the requirement more appropriately and we suggest the criterion 2(c) be amended to be consistent with B12.

***Criterion 2(d)***

Paragraph 2(d) requires an investment entity must have multiple unrelated investors that in aggregate hold a significant ownership interest in the entity. Please refer to our comments to Question 4 for further details of our concerns in this regard.

***Criterion 2(f)***

The Board should specify that only entities that provide financial information about their investment activities to their investors on fair value basis for evaluation purpose would qualify as an investment entity. If an entity provides information to investors on a consolidated basis such as consolidated revenue and liabilities of investees, this may indicate that investors have an objective for that investment beyond obtaining only financial returns.



### **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?**

(a) Yes, we agree.

(b) We believe that an entity is eligible if the investment-related services provided to entities other than the reporting entity are primarily for the better usage of existing resources, for example to share existing research results, investment recommendations or comments with other companies. And the services provided to these unrelated entities do not constitute the primary business objective of the service provider.

### **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.**

As mentioned in Q2, we have significant concerns with the "pooling of funds" requirements. We consider that there are no conceptual reasons why an investment entity that has a single investor could not be an investment entity. There are number of instances where funds that have a single investor exist. The most common is where a fund is established with a seed investor, where the fund manager seeks to build up a track record before marketing the fund to new investors. Other examples are sovereign funds and family trust funds. We believe that if such a fund is managed on a fair value basis with the explicit business purpose of investing for capital appreciation and investment income, it should also be qualify as an investment entity, if it meets all other criteria.

However, we appreciate the difficulty that could exist in practice to distinguish between a "true" investment entity and entities that are set up for other purposes. Therefore, we propose that the IASB provide further guidance or examples to re-emphasise the nature and the business purpose of an investment entity, which is to invest for capital appreciation, investment income, or both.

In addition, if the requirement that the investment entity should have investors that are unrelated to the parent and collectively hold a significant ownership interest in the entity is retained to any extent, then we are concerned that there could be instances where it is not possible for the investment entity to determine whether any of its investors are related to the parent entity. Some of the funds are held in nominee



names thus making it difficult to trace the background of the investors. Such determination would also be difficult in territories where state ownership is prevalent. Moreover, there is no definition as to what is "significant" ownership.

Given the broad definition of "related" in IAS 24 *Related Party Disclosures*, we therefore believe that the Board should use a narrower concept than "related" to determine which investors' interests should be aggregated to determine whether the candidate investment entity has an appropriate investor base to qualify under the exemption criteria. Specifically, we believe that the Board should focus only on control relationships if the intent is to prevent artificial structuring to achieve the criterion of "multiple investors" and should clarify this point in finalising the proposal.

#### **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?**

Yes. We consider that all investments held by an investment entity are best reflected at fair value through profit or loss. We believe that investment entities that also hold investment properties for the purpose of capital appreciation or investment income (including rental income) or both should treat them in the same manner as other financial instruments held for the same purpose. We therefore support the guidance in paragraph B17.

#### **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?**

We strongly disagree with the requirement that a parent, which is not an investment entity itself, should consolidate the controlled entities that it holds through subsidiaries that are investment entities. In our view, if application of the investment entity exception at the subsidiary level results in fair value information that is more useful than consolidated information then we would expect such fair value information to be relevant in the financial statements of the ultimate parent entity. We understand that the FASB proposals preserve the accounting treatment in its parent's financial statements and we support convergence with US GAAP in this area.

We are aware that the Board's decision not to allow a non-investment entity parent to retain the accounting of its investment entity subsidiaries was motivated by concerns over potential accounting inconsistencies and possibilities for abuse, for example, there might be a subsidiary that is an investment entity that holds an equity interest in the ultimate parent or has investments in the same investees as the parent. However, we believe that those concerns would be better addressed by prescribing the



accounting to be applied if such investments did exist (e.g. application of some form of consolidation accounting to those investments) with proper disclosure.

We do not share the concerns regarding the possibilities for abuse and the potential for off-balance sheet accounting for some assets because the conditions set in paragraph B6 of the ED ensure that the parent cannot obtain benefits other than those from capital appreciation and/or investment income from investees held by an investment entity subsidiary. Consequently, any arrangement between the parent and its investment entity subsidiary that modifies the nature of the investment activity would disqualify the entity from using the consolidation exception.

For these reasons we believe that it is unnecessary to prohibit a non-investment entity parent from retaining the accounting of its investment entity subsidiaries.

### **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?**

We are generally supportive of the proposed disclosure objective. However, we do not agree that IFRS 12 should continue to apply as it should be exempted together with IFRS 10 for an investment entity. We agree that the relevant disclosure requirements of IFRS 7 or IFRS 13 (depending on when entities start applying IFRS 13) would apply.

In addition, we are concerned that the long list of "examples" of additional disclosures in paragraph B19 of the ED may be taken as mandatory disclosure. As such, we recommend that the IASB streamline the list to those disclosures that are most decision-useful to users.

### **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?**

We do not agree with the proposals for prospective application as it would seriously impair the comparability of the current period and the comparative periods. That is, in the first year of application of the standard, an investment entity would measure its controlled investees at fair value whilst in the comparative period it would consolidate the underlying net assets of its controlled investees.

We understand that the Board is concerned about the undue use of hindsight in determining the fair value of investees. However, in order to qualify for the use of the exception, an investment entity must manage its investments at fair value. Therefore, we believe that an entity should already have the fair value information.





**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?
- (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?

We agree with the alternative proposed in paragraph (b) above. This would ensure consistency of treatment by investment entities as narrowly defined in the proposed IFRS on investment entities, whilst continuing to permit other entities which may not meet these new criteria to avail themselves of the fair value option under IAS 28 if they are currently eligible. As indicated in our responses to the Request for Views IASB Agenda Consultation 2011, we have concerns about the conceptual flaws and practical difficulties in the application of equity accounting. We therefore believe these concerns should be addressed before the measurement exemption is removed from any entities which currently may avail themselves of it.

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