IAASB International Auditing and Assurance Standards Board

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January 5, 2012

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Hans,

**Re: Comments on IASB's Exposure Draft on Investment Entities**

The International Auditing and Assurance Standards Board (IAASB) is pleased to provide comments on the IASB's Exposure Draft (ED) *Investment Entities.*

In formulating the comment letter, we have established a Working Group which monitors the development of IASB projects, including the project on Consolidation. The focus of the Working Group is to identify significant aspects of the IASB proposals which could pose difficulty in an auditing context and therefore where the IAASB members' expertise can add value to the IASB's deliberations. Overall, the Working Group feels that the standard is well-drafted. It has, though, identified a few areas that may require further consideration from a verifiability/auditability perspective. The attached Appendix includes the Working Group's views on what are likely to be the most substantive issues from an auditing perspective.

I hope you find the comments in the Appendix valuable. If you need clarification of our comments, please do not hesitate to contact us.

Yours sincerely,

Prof. Arnold Schilder
Chairman, IAASB

Cc. Prabhakar Kalavacherla, Member and Liaison Representative, IASB
Tomo Sekiguchi, IASB Liaison Working Group Chair, IAASB
Dan Montgomery, Deputy Chair and IASB Liaison Working Group Co-Chair, IAASB
James Gunn, Technical Director, IAASB

**IASB EXPOSURE DRAFT-**

**INVESTMENT ENTITIES**

**Comments of the IAASB's Working Group**

## OVERALL COMMENTS

As an exception to the consolidation model under IFRS 10 *Consolidated Financial Statements*, the ED requires an investment entity to measure the investees that it controls at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments.* The Working Group notes that management, especially in emerging markets, may not have full understanding of how to measure complex financial instruments or have little access to the expertise necessary to develop a reliable fair value measurement. The Working Group therefore welcomes the IASB's recent decision to undertake development of educational material regarding fair value measurement in response to these practical challenges. Although the scope of the anticipated material is not yet clear, the Working Group hopes that it will provide sufficient guidance regarding fair value measurement by various types of investment entities (e.g., mutual funds, private equity funds, and hedge funds). We draw your attention to the IAASB's recently published International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*.[1] This IAPN includes useful educational information relevant to understanding and auditing the valuation of financial instruments, especially when management uses third party pricing sources for valuation purposes. Some cross-referencing to the IAPN may be helpful to auditors.

**QUESTION 2— Criteria for determining when an entity is an investment entity**

## CLARIFICATION OF EVIDENCE TO SUPPORT MANAGEMENT ASSERTIONS

**Issue Description**

Paragraph 2 of the ED sets out criteria that an entity is required to meet to qualify as an investment entity. The Working Group generally feels that this paragraph provides robust criteria to ensure consistent application in determining which entities are investment entities within the scope of the standard.

The Working Group was particularly interested in paragraphs B7 to B11 of the ED. Though these paragraphs do not provide explicit documentation requirements of management, they do explain how the condition in paragraph 2(b) is demonstrated by providing examples of 'evidence' to support management's assertion. For instance, paragraph B8 of the ED states that "*<u>Evidence</u>* of the entity's express business purpose may be included in the entity's offering memorandum, publications distributed by the entity and other corporate or partnership document that indicate the investment objectives of the entity" *[italics* and <u>underlines</u> are added hereafter, when emphasizing particular word(s)]. In addition, paragraph B9 of the ED states that "An entity's express business purpose is also *<u>evidenced</u>* through its investment plans." The Working Group believes that these references to 'evidence' will assist both management and auditors when considering how to substantiate the particular assertions required by accounting standards.

Paragraph BC17 of the ED further states that "Although the exit strategy may vary depending on the nature and objectives of the investment, or on the maturity or development of the investee, or on market conditions, or other circumstances, *<u>potential exit strategies should be identified and documented in order to meet the definition of an investment entity.</u>*" The Working Group believes this reference is helpful to establish a common understanding between management and auditors regarding what should be

[1] International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*

expected to support management's assertions. For that reason, the intent may be further clarified by moving this reference to the application guidance section.

The Working Group also feels that other related areas of the ED may warrant further clarification. For example, paragraph 2(b) of the ED requires the entity to make an explicit commitment to a group of investors that the entity's purpose is investing to earn capital appreciation, investment income, or both, in order to meet the definition of an investment entity ('business purpose criterion'). In this connection, paragraph B9 states "An entity's express business purpose is also evidenced through its investment plans. Accordingly, an investment entity should have an *exit strategy* documenting how the entity plans to realize capital appreciation of its investments." The Working Group believes that this guidance is useful. However, it is unclear whether the IASB intends that an exit strategy is necessary for an entity to meet the definition of an investment: Albeit the statement is in paragraph BC17, the ED referred to it as an example of meeting the business purpose criterion.

**Actions that IASB May Wish to Consider in Addressing the Issue:**

The Working Group recommends that the IASB continue to explore enhancing the requirement to address evidence to support management assertions in the final standard. It also recommends the IASB clarify whether 'exit strategy' is necessary to substantiate the business purpose criterion (possibly elevating the reference to 'exit strategy' to paragraph 2), if the IASB intends that an 'exit strategy' is a necessary criterion.

**QUESTION 7—Disclosures**

**OBJECTIVE-BASED DISCLOSURE REQUIREMENT**

**Issue Description**

Paragraph 9 of the ED states that "An investment entity shall provide information to enable users of its financial statements to evaluate the nature and financial effects of the investment activities in which it engages." Paragraph B19 of the ED provides examples of additional disclosures that may be appropriate to meet the disclosure objective in paragraph 10.[2]

The Working Group agrees with the IASB on the need for the reporting entity to disclose information that is relevant for users of financial statements exercising the judgments. However, the Working Group wonders if the current description leaves the reporting entity too much scope in determining the nature and extent of what should be disclosed in the financial statements. In the Working Group's view, disclosure practice would be more consistent if the standard were to set out key matters related to non-consolidation of investment entities as minimum disclosures, while still allowing management to exercise judgment as to what additional disclosures would be appropriate. If the IASB considers that such an approach may give rise to duplicative information in financial statements, this might be alleviated by utilizing cross-references to other relevant note disclosures when the same information is required by other standards.

**Actions that IASB May Wish to Consider in Addressing the Issue:**

The Working Group recommends that the IASB set out disclosure requirements that are '*as the minimum'* necessary to meet the particular disclosure objectives.

[2] The Working Group wonders if the IASB intended the reference in the ED to be to paragraph 9.

In addition, the Working Group would like to draw your attention to the IAASB's comment letter on the IASB Agenda Consultation 2011.[3] In that letter, the IAASB noted the importance of cooperation and collaboration between the two Boards, and encouraged the IASB to consider developing an overarching disclosure framework that addresses matters such as how judgment should be exercised in determining additional disclosures beyond the minimum items required by accounting standards.

**OTHER COMMENTS**

## ALL FACTS AND CIRCUMSTANCES

**Issue Description**

Paragraph 3 of the ED refers to the need for an entity to consider *all facts and circumstances* existing at the time in deciding whether it meets the criteria to be considered an investment entity. Paragraph B3 makes a similar reference in the context of assessing whether it holds the collateral temporarily.

While the Working Group understands that it is not feasible to expect that standards specify a comprehensive set of matters to consider, the reference to 'all facts and circumstances' seems to establish an unduly onerous benchmark that will neither be practicable for management to implement, nor for auditors to audit. In the absence of additional guidance, it would be quite difficult for management and auditors to determine compliance with the requirement. The Working Group wonders if the IASB intends that these facts and circumstances are to be limited to those that are reasonably obtainable by management.

**Actions that IASB May Wish to Consider in Addressing the Issue:**

The Working Group recommends that the IASB include guidance explaining what is expected of management in reference to 'all facts and circumstances.'

## IMPLICIT ASSERTIONS

**Issue Description**

Paragraph 10(b) of the ED requires an investment entity to disclose information about whether the investment entity has provided financial or other support (explicitly or *implicitly*) to investees it controls, without having a contractual obligation to do so. In the context of the 'pooling of funds' criteria, paragraph B15 of the ED also explains that if the parent (or its related parties) has an *implicit* or explicit arrangement to acquire another investor's ownership interests in the investment entity, those investments shall be combined and treated as if they were owned by the parent for the purposes of evaluating compliance with this criterion.

The Working Group believes that it is difficult for auditors to obtain audit evidence regarding management's implicit assertions, as by their nature they are often not documented. In the absence of additional guidance (including whether such implicit assertions may be created by customary business practice or other means), management and auditors may face challenges in determining what constitutes implicit support.

**Actions that IASB May Wish to Consider in Addressing the Issue:**

The Working Group recommends that the IASB provide examples for management to determine what constitutes implicit assertions, to facilitate the consistent application of the standard.

[3] www.ifac.org/publications-resources/iaasb-comments-iasb-exposure-drafts

## CLARIFICATION OF OTHER TERMS

**Issue Description**

Paragraph 2(d) of the ED requires that the funds of the entity's investors be pooled so that the investors can benefit from professional investment management and that the entity has investors that are unrelated to the parent (if any). The Working Group believes that without explanatory materials the term 'unrelated' may be subject to different interpretations, including whether this determination should be made in the context of the definition enshrined in IAS 24 *Related Party Disclosures*.

In addition, paragraph 2(e) of the ED requires that substantially all of the investments of the entity are managed, and their performance is evaluated, on a *fair value basis* to meet the definition of an investment entity. The Working Group is not clear about whether the paragraph intends the fair value of these investments to be measured in accordance with IFRS 13 *Fair Value Measurement*. An investment entity may not fully comply with IFRS 13 in its fair value measurement for its internal management purposes.

**Actions that IASB May Wish to Consider in Addressing the Issue:**

The Working Group recommends that the IASB provide clarification about these terms in the final standard to facilitate the consistent application of the standard.