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International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom
Email: commentletters@ifrs.org

Dear Sir/Madam

SAICA SUBMISSION ON EXPOSURE DRAFT ON *INVESTMENT ENTITIES*

In response to your request for comments on the exposure draft on *Investment Entities,* attached is the comment letter prepared by Accounting Practices Committee (APC) of The South African Institute of Chartered Accountants (SAICA). This comment letter results from deliberations of the APC, which comprises members from reporting organisations, regulators, auditors, IFRS specialists and academics

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Sue Ludolph
Project Director – Financial Reporting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Paul O'Flaherty (Chairman of the Accounting Practices Committee)

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SAICA SUBMISSION ON EXPOSURE DRAFT ON *INVESTMENT ENTITIES*

GENERAL COMMENTS

Our commentators welcome the exposure draft (ED), although a minority support the alternative views of the three Board members who voted against the publication of the ED.

Although the majority of our commentators welcome the proposals in the ED, they believe that the consolidation exception should be extended to a parent of an investment entity that is not itself an investment entity. If the consolidation exception is not extended, then investment entities should be given a free choice as to whether they consolidate their subsidiaries or not, so that entities can decide whether they want to prepare two different sets of results.

In addition, of the majority who are supportive of the proposals, many believe that the proposed scope of the exception is too narrow. They believe it should be drafted to apply more widely based on the investor's business model for a particular investment, rather than attempting to define the type of investor for which it would be applicable. Accordingly, an alternative set of criteria has been proposed in our response to question 2 for determining which controlled entities should not be consolidated.

SPECIFIC COMMENTS

EXCLUSION OF INVESTMENT ENTITIES FROM CONSOLIDATION

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?

The majority of our commentators are supportive of an exception to the consolidation principle for investment entities, because they believe accounting for investments in controlled entities at fair value more appropriately reflects the way in which the investments are managed. In addition, in many cases, a controlling stake is obtained unintentionally (for example, as a result of corporate action of which the investor was not a party). Also, although the investor may have the ability to control the investee, they generally do not have the intention to exercise such control. In addition, business behaviour has been driven by the current accounting requirements, with many investment entities deliberately avoiding majority holdings so as not to have to consolidate.

Although the majority of our commentators are supportive, many are concerned that the proposed scope of the exception is too narrow. They believe the scope should be drafted to apply more widely based on the investor's business model for a particular investment, rather than restricting the scope to investment entities as defined in the proposal. Accordingly, an alternative set of criteria has been proposed for determining which controlled entities should not be consolidated. Please see our response to question 2.

The majority of our commentators believe that the consolidation exception should be extended to a parent of an investment that is not itself an investment entity (see our response to question 6). If the exception is not extended, then investment entities should be given a free choice as to whether they consolidate their subsidiaries or not. If consolidation would be required at the higher level, then some investment entities may prefer consolidating their subsidiaries in order to facilitate the parent's consolidation process.

A minority of our commentators do not believe that there should be an exception to the consolidation principle. Accordingly, the minority are supportive of the alternative views expressed by the three Board members who voted against the publication of the ED.

Accordingly, the responses to Questions 2-4 represent the views of the majority of our commentators.

CRITERIA FOR DETERMINING WHEN AN ENTITY IS AN INVESTMENT ENTITY (PARAGRAPHS 2 AND B1–B17)

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?

While the majority of our commentators are supportive of the proposed criteria set out in paragraphs 2 and B1-B17, many believe that the scope of the exception is too narrow. They are of the view that the exception should be based on an investor's business model for holding a particular investment, rather than defining an investment entity. They believe that the way in which the proposed scope exception is drafted is too restrictive.

A legal entity, such as a company, might have a division that invests in controlled entities for investment income and manages those investments on a fair value basis (such as a private equity division of a bank). Although paragraph 2(f) states that "*The entity can be, but does not need to be, a legal entity*", as a result of the criteria in paragraphs 2(c) and 2(d), a legal entity, such as the bank in this case, would not meet the proposed consolidation exemption. It is noted that this outcome is consistent with the proposal in paragraph 8 of the ED, that the parent of an investment entity that is not itself an investment entity should be required to consolidate all controlled entities. However, as noted in our response to Question 6, the majority of our commentators do not agree with this proposal. The consolidated information provided by the above-mentioned bank is considered to not be very useful to users as it is not the basis on which the controlled entity is managed.

Therefore it is proposed that criteria 2(c) and 2(d) should be deleted.

Also, instead of defining an investment entity, the majority of our commentators believe that there should be criteria for classifying controlled entities that should not be consolidated, but rather measured at fair value through profit or loss. The criteria should be based on the investor's business model for that particular controlled entity. It is noted that standards such as IFRS 9 – *Financial Instruments*, rely on the entity's business model for determining the appropriate accounting treatment. Accordingly, the following criteria are proposed:

- The primary intention of the investor is to manage the investment(s) for capital appreciation, investment income (such as dividends or interest), or both. This intention should include an exit strategy for the investment(s).

- The investor makes an explicit statement to its investors in its financial statements that its intention with managing these investments is to manage the investment(s) for capital appreciation, investment income (such as dividends or interest), or both.

- The investments that are held for capital appreciation, investment income or both, are clearly distinct from other investments of the reporting entity in the same investee. This includes:
  - The investee that has its own control and reporting systems; and
  - The investee reports separately to a board/ management team.

- The investees are separate autonomous businesses from the investor. This is supported by the fact that:
  - The investor does not obtain benefits, or has no objective of obtaining benefits, that extend beyond the benefits generally afforded to residual interest holders; for example, the acquisition or use of processes, intangible assets or technologies of the investee, and transactions not considered arm's length.
  - The investor does not provide significant administrative or support services to the investees.
  - The investee does not provide financing, guarantees or collateral for borrowings of the investor.
  - The investor does not direct the integration of the operations of the investees or the establishment of business relationships between investees.

- The investment is managed and the performance is evaluated on a fair value basis.

'NATURE OF THE INVESTMENT ACTIVITY' (PARAGRAPHS 2(a) AND B1–B6)

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?

The majority of our commentators believe that the answer to question (a) is yes, because such services are so closely related to the investment entity's own investment activities. However, the answer to question (b) is no, because the provision of such services to other entities would indicate that the entity's business purpose is not that of an investment entity.

However, since many of our commentators believe that the focus should be on the nature of the investment in each particular entity rather than on the investor, it should not matter what other services are provided. As long as the particular controlled investments meet the criteria we proposed in our response to Question 2, many of our commentators believe that those investments should not be consolidated.

'POOLING OF FUNDS' (PARAGRAPHS 2(d) AND B14–B16)

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.

The majority of our commentators believe that it would be appropriate for an entity with a single investor to be eligible to qualify as an investment entity as long as the single investor is itself an investment entity.

However, since many of our commentators believe that the focus should be on the nature of the investment in each particular entity rather than on the investor, it should not matter whether the entity has a single investor. As long as the particular controlled investments meet the criteria we proposed in our response to Question 2, many of our commentators believe that those investments should not be consolidated. Paragraphs 2d and B14 –B16 seek to define a class of entities.

MEASUREMENT GUIDANCE (PARAGRAPHS 6 AND 7)

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, the majority of our commentators (who are supportive of the proposals) believe that investment entities should be required to apply the fair value model in IAS 40, because it follows that all investments of investment entities should be measured at fair value. We do note that, although question 5 refers to financial assets, the ED does not mention financial assets. The final amendment should include such reference to financial assets.

Although the majority of our commentators are supportive of the proposal for the scope of the consolidation exception to apply to investment entities, as noted in our response to question 2, many believe that the consolidation exception should not be limited to investment entities, but should be applicable to all investors based on the particular business model. Therefore, it is not necessary to prescribe the accounting for other investments such as investment property and financial instruments because the relevant standards should simply be applied.

ACCOUNTING IN THE CONSOLIDATED FINANCIAL STATEMENTS OF A NON-INVESTMENT ENTITY PARENT (PARAGRAPH 8)

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?

The majority of our commentators do not agree. A parent should be exempt from consolidating investments that are held for capital appreciation and or investment income and are managed and evaluated on a fair value basis.

A company might have a venture capital division that invests in entities for capital appreciation and dividends, and the investments are evaluated on a fair value basis. Consolidating such information with the rest of the group on a line by line basis will not result in information that is more useful to users.

As a result, as noted in our response to Question 2, instead of defining an investment entity, many of our commentators believe that there should be criteria for classifying controlled entities that should not be consolidated by the direct investor or any intermediate or ultimate investor, but rather measured at fair value through profit or loss.

DISCLOSURE (PARAGRAPHS 9 AND 10)

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?

Yes, we agree.

TRANSITION (PARAGRAPH C2)

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?

While prospective application is generally regarded as simpler, and is therefore generally welcomed, many of our constituents, including preparers, were concerned about the lack of comparability in the first year of application. They do not believe that relief should be provided because, if the controlled investments are managed and evaluated on fair value basis, then entities should have the necessary fair values to enable retrospective application (without using hindsight).

We therefore believe that the proposals should be applied retrospectively, if practicable, otherwise the standard should be applied prospectively.

We also emphasise the need for the proposals to have the same effective date as IFRS 10 – *Consolidated Financial Statements,* so that entities are not forced to apply the new IFRS 10 consolidation model and then subsequently be given relief from consolidation.

SCOPE EXCLUSION IN IAS 28 (AS AMENDED IN 2011)

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?

On the basis that the Board proceeds with the proposals for the exemption to consolidation as set out in the ED, we believe that the measurement exemption in IAS 28 should be voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds. This is because, under the proposals for defining an investment entity, a separate legal entity that includes any of the aforementioned entities as a division, would not be able to continue applying the voluntary exemption in IAS 28.

Alternatively, under the proposals we put forward in our response to Question 2, IAS 28 could be amended such that any investments meeting those criteria would be required to apply the measurement exemption.