EFAMA

European Fund and Asset Management Association

EFAMA COMMENTS ON IASB'S REQUEST FOR INFORMATION

POST-IMPLEMENTATION REVIEW (PIR) OF IFRS 10, IFRS 11 AND IFRS 12

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I – Introduction and general comments

Follow-up on the comments shared during the outreach phase.

EFAMA is grateful for the opportunity to comment on the International Accounting Standards Board (IASB) Request for Information on the Post-Implementation Review of IFRS 10, 11 and 12. The comments below are a follow-up on the comments previously shared by EFAMA and the IASB during two meetings that took place on 8 November 2019 and recently on 5 May 2021.

The acknowledgment of investment entities is to be welcomed: The development of the consolidation standards was a very welcomed development in the asset management world. We were delighted to see an investment entity within the funds industry being acknowledged and catered for in IFRS. It was a very important shift for the industry, making IFRS much more user friendly. Broadly, when we look into an investment entity, where there is two predominant GAAPs (US GAAP and IFRS) - with local GAAPs being considered as well - these two GAAPs generally work well together, and while some differences remain, but the overall picture is very positive.

IFRS are mostly used by alternative funds and preferred by institutional investors: We see IFRS being mostly applied across the international alternative funds world and preferred by Asian, Latin American, Canadian investors or European institutional investors reporting under IFRS. European regulated mutual funds predominantly report under the local domicile GAAP, due to local legal and regulatory requirements in some EU jurisdictions to report under local GAAP. US GAAP remains the preference for US investors.

Preparers views on the application of IFRS 10: From a funds' preparer perspective, we haven't seen any significant concerns and the standards are being applied quite consistently by preparers. The application of IFRS 10 from an institutional investor perspective, especially in cases of investing through partnership entities, remains an area of significant judgement with different interpretations of the determination of an agent or a principal. We have different assessments being made on the investment entity exception, with the fact pattern assessments made for each arrangement.

Subsidiaries: In the investment funds world, funds are split in two type of funds: i) on one side, the so called mutual funds (more regulated products); and ii) on the other side, the alternative (more private debt, private equity or real estate) type of funds. In mutual funds, it is not common to see subsidiaries; but you may have it when you are investing in certain markets where you need to have a company based in the country of investment (for certain tax purposes). So, while it is possible to have funds with subsidiaries, it is not predominant and there are only few isolated cases in case of Mutual Funds. We see the creation of subsidiaries on the alternative side where private asset/private equity/real estate is the main mechanism. Where you have these types of funds, they are usually unlisted entities and they tend to invest through unlisted subsidiaries.

Some structures fail the investment entity exception: We see certain Real Estate (RE) funds tend to fail the investment entity exception, which would be largely inconsistent with other investment funds. These RE funds typically fail to meet the investment entity exception for the following reasons: i) first, because some open ended RE funds fail the exit strategy criterion (as they might not necessarily have a documented exit strategy); ii) secondly, some opportunistic, closed ended RE funds may be involved in the development and management of property, so they fail in the investment services criteria.[1] This is one

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[1] In this case, if they are acquiring a direct investment in property under IAS 40, they would be able to apply fair value and the application of the identification criteria to identity the investment entity is generally consistent.

of the questions we have taken the opportunity to explain to the IASB's team during the outreach phase and this might be one area where the IASB wants to enquire again.

More examples would be welcomed in situations where no one consolidates: In practice, it is common to have funds where no consolidation is applied (e.g. funds of one). This is a common situation that we see and can cause issues for auditors.[2] When discussing the topic with the IASB, we concluded that it would be good to have more examples when dealing with these kind of structures.

The relevant activities of an investee in understanding what an investment entity is: We have looked into the involvement with the investee – indication that we can't find out the purpose of this involvement – to understand if it is easy to make a judgment of the involvement (like participation entities). They also need to meet the definition. The purpose is generally always for capital appreciation and/or investment income generation. Under the AIFMD, private equity entities are defined as investment entities – in that case the question arises whether these private equity entities/venture capitalists can use the consolidation exception under IFRS (for investment entities). Therefore, it is preferred to include guidance on what entities will meet the three essential elements of the definition of an investment entity and the four typical characteristics.

Application of the consolidation exception for investment entities: The application of the consolidation exception is rather consistent and in practice the judgment is applied consistently (and this is also an anti-abuse rule).

Ownership Interests: Some EFAMA members have some concerns on the interpretation of "ownership interests" ("OI"), as IFRS 10.B85W seems to require that the investment entity only issues debt with a significant OI (not normal debt) and thus requires that the debt holders are exposed to the variable returns from changes in the fair value of the entity's net assets. IFRS 10.BC265 states that an entity that provides its investors with only a return of their investment plus interest should not qualify as an investment entity. The issue is how much debt is allowed to still comply with the ownership interest criteria.[3]

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[2] For example, Limited Partners have 90% of the fund - the majority of the returns – but they don't have power over the activity. The General Partner will decide freely. This is really an extreme example and, in theory, under this situation no one consolidates the entity. **In Germany** if you have a single investor fund you should consolidate it. However, not due to the majority of risk. In a German fund scenario, kick-out rights do not really apply in the pure sense of the meaning. What you have instead with an open-ended fund is you will always have the chance to give back your shares and that's what they consider the "kick-out" right of the investor – knowing quite well that, in that scenario the fund choses to exist – that's the problem that you need to overcome. Now, from the perspective of the standard in connection with the German fund law, you could have a different view. If a client has a different view and really presses you saying that it is not really a kick-out right, you may have a hard time arguing back. At least in open-ended funds when you have a single-investor fund scenario, it is consolidated. But not for majority e.g. if you have 90%, the answer could be different again. **In the Netherlands** you also have the discussion whether you are not a principal, but more acting as an agent. If you have more investors, it is easy to demonstrate that you are more in an agent situation. **In Germany**, when nobody has a kick-out right or if you have 60/75%, as you have different investors and no one has the right to kick the asset manager out, then you could end up in a scenario where someone has the majority of rights and it could be e.g. 90/95% of the fund and still could result in no consolidation.

[3] Imagine a case where the investor holds only a very small portion of the equity and the investment capital is brought in via fixed interest debt securities they issue. The debt instruments issued are fixed interest debt securities which are redeemed at 100% (fixed return) – the issue is we still have an OI, which is quite small, but it is an OI – the entire investment portfolio, say 80% are financed by debt (notes, not bank debt). The question arising is, whether that is still a scenario where the investment entity exception could be applied or if the OI criteria is not met? Or is this an area where you need to have more than 50% of OI and they would need to finance more than half of it via their own money – or is that 100% of both the OI and the debt needs to be variable thus is, paying back NAV? Which would take the financing from banks out of the funds' definition as well (and you need to have 100% equity financing). This seems to be quite unclear when you need to apply it. The IASB understanding on the exposure to variable returns is that the standard is quite clear and we need to work with a wide notion. The standard says explicitly you can have fixed return instruments and an exposure to the variable returns to the extent that you can have a credit loss on that. So, variable returns doesn't mean necessarily profits or losses strictly, it is also variable returns in terms of changes in the cashflows because the investee does not generate the sufficient cashflows.

IFRS 11 and 12: EFAMA members have minor concerns with respect to IFRS 11 (which is not as relevant for the industry) as well as with IFRS12 (the definition of structured entities is sometimes a challenge, however, overall this has no material impact and typically impacts only the disclosures).

IFRS 9: We are delighted to see the funds industry being acknowledged and catered for in these standards, and we would like to see the treatment of an investment entity, in a consistent manner – when commenting on IASB's Discussion Paper regarding FICE, we have clearly suggested IFRS 9 should be amended to include a new asset category for "Investment Entity" holdings as defined under IFRS 10.

II – EFAMA's reply to the questions for respondents

Besides the aforementioned general comments, EFAMA takes the opportunity to comment more in detail on the specific questions set out in the Request for Information.

Question 1—Your background - To understand whether groups of stakeholders share similar views, the Board would like to know: (a) your principal role in relation to financial reporting. Are you a user or a preparer of financial statements, an auditor, a regulator, a standard-setter or an academic? Do you represent a professional accounting body? If you are a user of financial statements, what kind of user are you, for example, are you a buy-side analyst, sell-side analyst, credit rating analyst, creditor or lender, or asset or portfolio manager? (b) your principal jurisdiction and industry. For example, if you are a user of financial statements, which regions do you follow or invest in? Please state whether your responses to questions 2–10 are unrelated to your principal jurisdiction or industry.

EFAMA, is the voice of the European investment management industry, represents 28 member associations (different jurisdictions), 57 corporate members and 23 associate members. At end Q4 2020, total net assets of European investment funds reached EUR 18.8 trillion. These assets were managed by more than 34,350 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,650 AIFs (Alternative Investment Funds).

Question 2(a) - In your experience: (i) to what extent does applying paragraphs 10–14 and B11–B13 of IFRS 10 enable an investor to identify the relevant activities of an investee? (ii) are there situations in which identifying the relevant activities of an investee poses a challenge, and how frequently do these situations arise? In these situations, what other factors are relevant to identifying the relevant activities?

We have no additional comments.

Question 2(b) - In your experience: (i) to what extent does applying paragraphs B26–B33 of IFRS 10 enable an investor to determine if rights are protective rights? (ii) to what extent does applying paragraphs B22–B24 of IFRS 10 enable an investor to determine if rights (including potential voting rights) are, or have ceased to be, substantive?

We have no additional comments.

Question 2(c) - In your experience: (i) to what extent does applying paragraphs B41–B46 of IFRS 10 to situations in which the other shareholdings are widely dispersed enable an investor that does not hold a majority of the voting rights to make an appropriate assessment of whether it has acquired (or lost) the practical ability to direct an investee's relevant activities? (ii) how frequently does the situation in which an investor needs to make the assessment described in question 2(c)(i) arise? (iii) is the cost of obtaining the information required to make the assessment significant?

We have no additional comments.

Question 3(a) - In your experience: (i) to what extent does applying the factors listed in paragraph B60 of IFRS 10 (and the application guidance in paragraphs B62–B72 of IFRS 10) enable an investor to determine whether a decision maker is a principal or an agent? (ii) are there situations in which it is challenging to identify an agency relationship? If yes, please describe the challenges that arise in these situations. (iii) how frequently do these situations arise?

No comments.

Question 3(b) In your experience: (i) to what extent does applying paragraphs B73–B75 of IFRS 10 enable an investor to assess whether control exists because another party is acting as a de facto agent (ie in the absence of a contractual arrangement between the parties)? (ii) how frequently does the situation in which an investor needs to make the assessment described in question 3(b)(i) arise? (iii) please describe the situations that give rise to such a need.

No comments.

Question 4(a) In your experience: (i) to what extent does applying the definition (paragraph 27 of IFRS 10) and the description of the typical characteristics of an investment entity (paragraph 28 of IFRS 10) lead to consistent outcomes? If you have found that inconsistent outcomes arise, please describe these outcomes and explain the situations in which they arise. (ii) to what extent does the definition and the description of typical characteristics result in classification outcomes that, in your view, fail to represent the nature of the entity in a relevant or faithful manner? For example, do the definition and the description of typical characteristics include entities in (or exclude entities from) the category of investment entities that in your view should be excluded (or included)? Please provide the reasons for your answer.

In our experience, the current definition and the description of the typical characteristics of an investment entity does substantially lead to consistent outcomes when applied to different investment fund structures and strategies. We are not aware of any significant interpretation issues with the current requirements. We agree with the current IFRS 10 requirements, where the focus should continue to be on the business model rather than the structure of the entity. We do however note that applying the IFRS 10 requirements for investment funds investing in Real Estate Assets ("RE Funds") may be subjective and we would recommend that further application guidance is added around the following areas:

- Business Purpose (IFRS 10.B85D) – Certain RE Funds are involved in the development and management of property they acquire as part of an overall investment strategy to generate returns to investors from capital appreciation. However, it's not clear how RE Funds should assess whether such specific property development or management activities represent a separate substantial business activity or a separate substantial source of income when such activities form part of the overall investment strategy.

- Exit Strategies (IFRS 10.B85F) – IFRS 10 requires investment entities to evidence potential exit strategies for the different type of investments held, including a "substantive time frame" for exiting such investments. It would helpful if further guidance is provided around the "substantive time frame" requirement especially in the context of RE Funds which are open-ended (i.e. offer investor the ability to redeem and recognise any capital appreciation), have no defined fund life, and may hold property for a longer period. We also note that in practice some believe that having set up a limited life entity is sufficient to demonstrate the existence of a documented exit strategy. It may not necessarily be the case. We suggest that it may be useful for the Board to provide illustrative examples of what an exit strategy is, i.e. a governance strategy addressing exit plans rather than just setting an ultimate disposal date.

Also further application guidance is welcome on the degree of involvement that an investment entity may have in managing the activities of an investee. Especially for private equity entities this is relevant, as these entities will meet the definition of an investment entity under the AIFMD. For using the consolidation exception of IFRS 10, they have to meet the definition of an investment entity under that standard. The business purpose is generally always capital appreciation and/or investment income generation. The application guidance should cover in what circumstances involvement in managing the activities of an investee will still meet the three essential elements of the definition of an investment entity and the four typical characteristics of IFRS 10.

Question 4(b) In your experience: (i) are there situations in which requiring an investment entity to measure at fair value its investment in a subsidiary that is an investment entity itself results in a loss of information? If so, please provide details of the useful information that is missing and explain why you think that information is useful. (ii) are there criteria, other than those in paragraph 32 of IFRS 10, that may be relevant to the scope of application of the consolidation exception for investment entities?

We agree with the current IFRS 10 requirements whereby intermediate investment entities should continue to be measured at fair value rather than consolidated (entities such as subsidiaries established solely for legal, tax or regulatory purposes).

We also note that in practice some investment entities do voluntary disclose additional information on the nature and fair value of any significant classes of investments held through related intermediate investment entities which can further aid users of financial statements in gaining a better understanding of underlying market risk exposures held through intermediate investment entities.

We would suggest a similar new non-mandatory disclosure is considered in the review of the current IFRS 12.19A-19G requirement, focusing on significant classes of investments held by related intermediate investment entities.

See the example below:

X. Market risk [Extract]

X.X Market risk arising from price risk [Extract]

The Entity's indirect exposure to price risk held through intermediary investment entities were concentrated in the following industries and geographic locations as at [Balance Sheet Date].

Industry type	***Location***	***Fair value CCY '000***	***% of NAV***
Real Estate	*United Kingdom*	*5,000*	*50.00*
Industry 2	*Country 2*	*5,000*	*50.00*
Total		*10,000*	***100.00%***

Question 5(a) In your experience: (i) how frequently do transactions, events or circumstances arise that: (a) alter the relationship between an investor and an investee (for example, a change from being a parent to being a joint operator); and (b) are not addressed in IFRS Standards? (ii) how do entities account for these transactions, events or circumstances that alter the relationship between an investor and an investee? (iii) in transactions, events or circumstances that result in a loss of control, does remeasuring the retained interest at fair value provide relevant information? If not, please explain why not, and describe the relevant transactions, events or circumstances.

No comments.

Question 5(b) In your experience: (i) how do entities account for transactions in which an investor acquires control of a subsidiary that does not constitute a business, as defined in IFRS 3? Does the investor recognise a non-controlling interest for equity not attributable to the parent? (ii) how frequently do these transactions occur?

No comments.

Question 6 In your experience: (a) how widespread are collaborative arrangements that do not meet the IFRS 11 definition of 'joint arrangement' because the parties to the arrangement do not have joint control? Please provide a description of the features of these collaborative arrangements, including whether they are structured through a separate legal vehicle. (b) how do entities that apply IFRS Standards account for such collaborative arrangements? Is the accounting a faithful representation of the arrangement and why?

No comments.

Question 7 In your experience: (a) how frequently does a party to a joint arrangement need to consider other facts and circumstances to determine the classification of the joint arrangement after having considered the legal form and the contractual arrangement? (b) to what extent does applying paragraphs B29–B32 of IFRS 11 enable an investor to determine the classification of a joint arrangement based on 'other facts and circumstances'? Are there other factors that may be relevant to the classification that are not included in paragraphs B29–B32 of IFRS 11?

No comments.

Question 8 In your experience: (a) to what extent does applying the requirements in IFRS 11 enable a joint operator to report its assets, liabilities, revenue and expenses in a relevant and faithful manner? (b) are there situations in which a joint operator cannot so report? If so, please describe these situations and explain why the report fails to constitute a relevant and faithful representation of the joint operator's assets, liabilities, revenue and expenses.

No comments.

Question 9 In your experience: (a) to what extent do the IFRS 12 disclosure requirements assist an entity to meet the objective of IFRS 12, especially the new requirements introduced by IFRS 12 (for example the requirements for summarised information for each material joint venture or associate)? (b) do the IFRS 12 disclosure requirements help an entity determine the level of detail necessary to satisfy the objective of IFRS 12 so that useful information is not obscured by either the inclusion of a large amount of detail or the aggregation of items that have different characteristics? (c) what additional information that is not required by IFRS 12, if any, would be useful to meet the objective of IFRS 12? If there is such information, why and how would it be used? Please provide suggestions on how such information could be disclosed. (d) does IFRS 12 require information to be provided that is not useful to meet the objective of IFRS 12? If yes, please specify the information that you consider unnecessary, why it is unnecessary and what requirements in IFRS 12 give rise to the provision of this information.

No comments.

Question 10 Are there topics not addressed in this Request for Information, including those arising from the interaction of IFRS 10 and IFRS 11 and other IFRS Standards, that you consider to be relevant to this Post-implementation Review? If so, please explain the topic and why you think it should be addressed in the Post-implementation Review.

No comments.

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About EFAMA:

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