

STAFF PAPER

October 2014

IASB Meeting

IASB Mar & Apr 2014
IFRS IC Nov 2013 & Jan 2014

Project	Narrow-scope amendments to IFRS 10 <i>Consolidated Financial Statements</i> and IAS 28 <i>Investments in Associates and Joint Ventures</i>		
Paper topic	Exemption from preparing consolidated financial statements		
CONTACT(S)	Koichiro Kuramochi	kkuramochi@ifrs.org	+44 (0)20 7246 6496

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. The Exposure Draft ED/2014/2 *Investment Entities: Applying the Consolidation Exception* (the 'ED') was published in June 2014. It includes a proposal for an amendment to IFRS 10 *Consolidated Financial Statements* 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.

Objective

2. The objective of this paper is to provide an analysis of the comment letters received on the proposal to amend IFRS 10 in relation to the exemption from preparing consolidated financial statements and to obtain the IASB's decision on the finalisation of this amendment.

Structure of the paper

3. This paper:
 - (a) provides a description of the issue that led to the proposed amendment;

- (b) analyses the comments received as part of the Exposure Draft process;
and
- (c) asks the IASB to confirm whether it agrees with the staff recommendation to proceed with the proposed amendment.

Description of the issue

4. The IFRS Interpretations Committee (the ‘Interpretations Committee’) received a request to clarify whether the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 should remain available to a parent entity that is a subsidiary of an investment entity parent (but is not itself an investment entity), if the conditions set out in paragraph 4(a)(i)–(iii) of IFRS 10 are met but the investment entity parent does not consolidate any of its subsidiaries. Instead, the investment entity parent prepares financial statements in which its subsidiaries are measured at fair value in accordance with paragraph 31 of IFRS 10.
5. The IASB observed that the exemption for intermediate parent entities was previously provided, because the cost of requiring each intermediate parent entity within a group to prepare consolidated financial statements would be burdensome in cases in which the conditions in paragraph 4(a) of IFRS 10 are met. The IASB had previously decided that in such cases, the combination of information available in the consolidated financial statements of the higher level parent and the separate financial statements of the intermediate parent entity, together with the conditions in paragraph 4 of IFRS 10, provide sufficient information and safeguards for the users of the intermediate parent’s financial statements.
6. The IASB observed that, when an investment entity measures its interest in a subsidiary at fair value, the disclosures required by IFRS 12 *Disclosure of Interests in Other Entities* are supplemented by those required in IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement*. Accordingly, the IASB decided that this combination of information provides sufficient grounds to retain the existing exemption from presenting consolidated financial statements for subsidiaries of investment entities that are themselves

parent entities. Removing the exemption so that any subsidiary of an investment entity that prepares IFRS financial statements would have to present consolidated financial statements in such circumstances could result in significant additional costs, without commensurate benefits. The IASB noted that this is contrary to its intention in providing the consolidation exception to investment entities. Its intention was to help provide relevant information and to reduce costs, as described in paragraphs BC309 and BC314 of IFRS 10.

7. Accordingly, the IASB proposed to amend IFRS 10 to confirm that the exemption from preparing consolidated financial statements, as 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 that measures its subsidiaries at fair value. The IASB also proposed to make a consequential amendment to paragraph 17 of IAS 28 *Investments in Associates and Joint Ventures* for the same reasons. Paragraph 17 of IAS 28 uses the same criteria as paragraph 4(a) of IFRS 10 to provide an exemption from applying the equity method for entities that are subsidiaries and that hold interests in associates and joint ventures.

Comment letter analysis

8. In this section, we discuss and analyse the comments received from interested parties on the ED during the comment period, which ended on 15 September 2014.
9. In relation to the exemption from preparing consolidated financial statements, Question 1 of the ED states as follows:

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 should 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?

10. The IASB received 80 comment letters on the ED. With respect to the respondents who replied to Question 1:
- (a) approximately four-fifths of the respondents fully agreed with the proposal;
 - (b) some of the respondents disagreed with the proposal, mainly on the grounds of loss of information; and
 - (c) some of the respondents generally agreed with the proposal but suggested some changes in wording.
11. The main reasons why those respondents supported the proposal are because they agreed with the intention of the IASB as stated in the Basis for Conclusions on the ED, especially:
- (a) the amendment clarifies the extent to which the exemption applies;
 - (b) the amendment is appropriate from the cost and benefit ground;
 - (c) paragraph 4(i)–(iii) of IFRS 10 provides appropriate safeguards; and
 - (d) IFRS 12, IFRS 7 and IFRS 13 provide adequate information to investors.
12. The main reasons (Issue 1) why some of the respondents disagreed with the proposed amendments are:
- (a) on the grounds of loss of information; and
 - (b) that stakeholders would not necessarily be protected by the safeguards
13. Some of the respondents who agreed with the proposal expressed the following concerns:
- (a) Issue 2: it would conflict with national legislation; and
 - (b) Issue 3: there is a lack of clarity on the transition requirements.
14. In addition, some of the respondents who agreed with the proposal suggested some changes in wording:
- (a) Issue 4: clarifying the scope of the exemption;
 - (b) Issue 5: applicability of IFRS 12;

- (c) Issue 6: modifying the wording of paragraph 4(b) of IFRS 10; and
- (d) Issue 7: deleting paragraph 4(a)(iv) of IFRS 10.

15. We will analyse each one of these issues in the following paragraphs.

Issue 1: loss of information and stakeholders would not necessarily be protected by the safeguard

16. Some respondents¹ expressed concerns about loss of information, because the ultimate parent's investment entity financial statements do not provide the same level of information as consolidated financial statements. For example, two respondents stated that (emphasis added):

... if the ultimate parent is an investment entity and accounts for its subsidiaries at fair value rather than consolidation, then *the consolidated accounts and activities of each subsidiary are not similarly presented and therefore do not provide a similar level of information.* [IOSCO]

... the potential users would rather be interested in the consolidated financial statements of the entity or its corporate parent (which is organizationally and financially linked with that subsidiary) than in the information relevant to equity holders of the fund, such as a subjective assessment of the fair value of the subsidiary group. [PASC]

17. Some respondents² also commented that stakeholders are not necessarily protected by the safeguards in paragraph 4(a). For example, two respondents stated that (emphasis added):

... *in particular non-investors, such as suppliers, customers and employees might neither be adequately informed about the financial position and performance of the concerning*

¹ The International Organization of Securities Commissions (IOSCO), the Australian Accounting Standards Board (AASB) and the Polish Accounting Standards Committee (PASC).

² European Securities and Market Authority (ESMA), Instituto De Contabilidad Y Auditoria De Cuentas (ICAC) and Raad voor de Jaarverslaggeving (Dutch Accounting Standards Board (DASB)).

subsidiary nor have the opportunity to object to the parent not presenting consolidated financial statements. [ESMA]

... this proposal as it is in our opinion not in the interest of users such as for instance banks, suppliers, customers, employees and government agencies at the level of the parent entity that is a subsidiary of an investment entity. Those users have different interests than the investor users at the investment entity level. We do not think that the disclosures currently required at the investment entity level can substitute for a full set of consolidated financial statements with respect to those users. These disclosures concentrate on the perspective of the investor users and their needs. Users that trade or deal, or consider to do so, with the parent company and its subsidiaries would have a more particular focus on for example the financial condition, bank covenants, cash flows and going concern issues rather than fair value information. *The current IFRS 12 disclosure requirements, including any summarised financials, do not extend to such information and are entirely insufficient to compensate users for the missing information, e.g. information that can be found in the notes to the consolidated financial statements. [DASB]*

Staff analysis and recommendation

18. We noted that these respondents suggested that an intermediate parent that is the subsidiary of an investment entity should present consolidated financial statements. This is because the ultimate parent's investment entity financial statements do not provide the same level of information as consolidated financial statements and non-investor users of the intermediate parent, such as banks, suppliers, customers, employees and government agencies could not obtain adequate information.
19. We noted that the *Conceptual Framework* names 'existing and potential investors, lenders and other creditors' as the primary users of general purpose financial reports.

OB5 Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.

20. Consequently, we think that our analysis should focus on whether the intermediate parent's other lenders or creditors will be adversely affected by the inclusion of the intermediate parent at fair value in its parent's financial statements instead of being consolidated on a line-by-line basis.
21. We think that these users (ie the intermediate parent's other lenders and creditors) receive only limited information about the intermediate parent through the consolidated financial statements of the ultimate parent using ordinary consolidation requirements. Accordingly, in our experience, a bank that provides significant lending to an entity may require certain periodic reporting from the intermediate parent to the bank as a condition of the loan. We also noted that in practice a supplier may use credit rating information instead of consolidated financial statements of the ultimate parent entity when making decisions about providing credit. As such, we question whether the additional cost is justifiable compared with the reported loss of information from the ultimate parent financial statements. As noted during discussions to develop the ED, we are particularly concerned whether the benefits that the IASB expected from *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which was issued in October 2012, would be undermined by requiring all intermediate parent entities that are subsidiaries of investment entity parents to prepare consolidated financial statements. Accordingly, we do not consider that the loss of information for lenders and creditors at the level of the ultimate parent would justify the cost of requiring consolidated financial statements of the intermediate parents. We noted that many respondents supported the proposal on cost-benefit grounds.

Issue 2: conflict with national legislation

22. Some respondents³ who agreed with the proposal expressed the concern that the exemption would conflict with national legislation. For example, one respondent stated that (emphasis added):

... there might a conflict between the IFRS and the national legislation in certain EU countries. In some jurisdictions, Company Law only allows for a parent company to be exempted from the consolidation requirements if the entity itself is a subsidiary and its parent or ultimate parent company prepares consolidated financial statements. [FEE]

Staff analysis and recommendation

23. We do not consider that the exemption would conflict with national legislation, because this is not a *prohibition* against producing consolidated financial statements but is only an *exemption* from doing so. Because this is only an exemption, if an intermediate parent chooses to prepare consolidated financial statements, or local legislation requires the production of consolidated financial statements of an intermediate parent, the entity can do so and still comply with IFRS.

Issue 3: a transition requirement

24. One respondent⁴ who agreed with the proposal suggested clarifying the transition requirement as follows:

... We suggest it be clarified that the quantitative information required by paragraph 28(f) of IAS 8 is only required for the annual period immediately preceding the date of initial application of this IFRS, and that while an entity may also present this information for the current period or for earlier

³ Fédération des Experts Comptables Européens (FEE) [The Federation of European Accountants], the Association of Chartered Certified Accountants (ACCA) and the National Accounting Standards Board at the National Organization for Financial Accounting and Reporting Standards (NOFA Foundation).

⁴ PricewaterhouseCoopers (PwC).

comparative periods it is not required to do so. This approach would be consistent with the transition requirements of IFRS 10 para 2A. [PwC]

Staff analysis and recommendation

25. We agree with the comment and our recommendation is to clarify that the quantitative information required by paragraph 28(f) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* should only be required for the annual period immediately preceding the date of initial application of this Standard. We agree with this suggestion for the reasons given by the respondent.

Issue 4: clarifying the scope of the exemption

26. Some respondents⁵ who agreed with the proposal suggested changing the wording of the exemption to avoid ambiguity.

27. One respondent suggested introducing the definitions of an ultimate parent and an intermediate parent:

.... We suggest providing a clearer description by, for example, introducing the definitions of an ultimate parent and an intermediate parent as stated in IAS 28. This could allow users of the standard to have an intuitive understanding on the consolidation exemption to an intermediate parent.
[CASC]

28. Another respondent suggested the following wording for paragraph 4(a)(iv) of IFRS 10 (the recommended addition is underlined):

... its ultimate or any intermediate parent produces financial statements that are available for public use and comply with IFRSs, including the requirements of this IFRS to consolidate subsidiaries or measure them at fair value, pursuant to the provisions of paragraph 31 of this IFRS for investment entities. [GLASS]

⁵ China Accounting Standards Committee (CASC), PwC and Grupo Latinoamericano de Emisores de Normas de Información Financiera (GLENIF) (Group of Latin-american Accounting Standard Setters (GLASS)).

Staff analysis and recommendation

29. We understand the concerns and we propose to change the wording of paragraph 4(a)(iv) of IFRS 10 by adding ‘, in accordance with paragraph 31 of this IFRS’. We also propose a similar amendment to paragraph 17(d) of IAS 28.

Issue 5: applicability of IFRS 12

30. One respondent⁶ claimed that some paragraphs appear to be inconsistent as follows:

... We consider it appropriate to describe such consolidated financial statements as "special purpose" financial statements rather than "IFRS financial statements", and welcome the clarification provided by the proposed amendment. We believe there is confusion as to whether the financial statements produced by an investment entity should be viewed as consolidated or separate financial statements:

- IFRS 10 para 32 requires that an investment entity consolidate a subsidiary which provides services relating to the investment entity's investment activities.
- However, IAS 27 para 8A requires that an investment entity present separate financial statements as its only financial statements.

The requirements of the two standards would appear inconsistent. We are also aware that there might be local regulatory requirements in some jurisdictions that traditional separate financial statements in accordance with IAS 27 be produced and some might consider the above paragraphs prevent them from doing so. To address this concern, we suggest that the financial statements to be prepared by an investment entity be defined. [PwC]

⁶ PwC.

31. Then, the respondent raised a concern on the applicability of IFRS 12 as follows:

... IAS 27 para 8A indicates that an investment entity presents separate financial statements. Although IFRS 12 paras 19A to 19G 12 contain disclosure requirements for investment entities, as IFRS 12 para 6 scopes out separate financial statements (unless there are any unconsolidated structured entities), this would appear to scope investment entities from the requirements of the standard.

We think that our proposal in question 1 to define investment entity financial statements as being different from separate financial statements will be an effective method of addressing this problem. [PwC]

32. The respondent suggested the following wording for paragraph 4(c) of IFRS 10 to define investment entity financial statements as being different from separate financial statements:

... an investment entity that is required, in accordance with paragraphs 31 and 32 of this IFRS, to measure all of its subsidiaries at fair value through profit or loss other than subsidiaries which provide services that relate to the investment entity's investment activities and are consolidated. Such financial statements produced by the investment entity (regardless of whether they do consolidate subsidiaries which provide services that relate to the investment entity's investment activities) are referred to as 'investment entity financial statements. [PwC]

Staff analysis and recommendation

33. We do not consider paragraph 32 of IFRS 10 and paragraph 8A of IAS 27 to be inconsistent, because paragraph 8A of IAS 27 describes the investment entity that measures all of its subsidiaries at fair value in accordance with paragraph 31 of IFRS 10. In other words, the paragraph describes the investment entity that does not have a subsidiary providing investment related services in accordance with paragraph 32 of IFRS 10. In addition, we think that paragraph 16A of IAS 27 clearly states that IFRS 12 is applicable to the investment entity that prepares

separate financial statements as its only financial statements. However, we understand that paragraph 6(b) of IFRS 12 is not clear on that point. We therefore agree that there is a concern about the interaction between IFRS 12 and IFRS 10/IAS 27.

34. We consider that there are some alternative ways to address the issue of applicability of IFRS 12, as follows:
- (a) Alternative 1: define investment entity financial statements as being different from separate financial statements, in paragraph 4(c) of IFRS 10 as proposed by the respondent.
 - (b) Alternative 2: amend paragraph 6(b) of IFRS 12 to make clear that IFRS 12 applies to separate financial statements of investment entities, if those financial statements are its only financial statements.
 - (c) Alternative 3: deem investment entity financial statements to be consolidated financial statements.
35. We consider that Alternatives 1 and 3 would have merit, because they do not depend on whether an investment entity has service subsidiaries or not. Currently, an investment entity produces separate financial statements if it does not have a service subsidiary, while an investment entity produces consolidated financial statements if it has a service subsidiary. Notwithstanding this difference, the nature of the investment entity's financial statements is not different. However, we are concerned that Alternatives 1 and 3 could have broader consequences.
36. Taking into consideration the intention to make these amendments before the end of 2014, we recommend Alternative 2. We think this will adequately address the concern identified with the minimum of changes required within the short time scale. We think that this change should be made as part of finalising these amendments, because the provision of IFRS 12 disclosures was part of the basis for the IASB's conclusions for the proposed amendments.

Issue 6: the wording of paragraph 4(b) of IFRS 10

37. One respondent⁷ who agreed with the proposal commented that the proposed wording for paragraph 4 of IFRS 10 may have an unintended consequence, as follows:

... We believe that the proposed wording of paragraph 4 may have an unintended consequence for the exemption for post-employment benefit plans or other long-term employee benefit plans to which IAS 19 *Employee Benefits* applies. Although the current wording is not entirely clear, we have read paragraph 4(b) as carrying forward from SIC-12 the exemption from consolidating these plans - i.e. the plans as investees. However, the proposed amendment now reads as addressing the accounting in the financial statements of the plan itself i.e. the plan as parent - rather than in the financial statements of the investor. Therefore, the wording of this paragraph should be amended. [KPMG]

Staff analysis and recommendation

38. We agree with the comment made that the proposed amendments to paragraph 4 may have an unintended consequence. We therefore propose that we revise the wording when drafting the final amendments to avoid this unintended consequence.

Issue 7: deleting paragraph 4(a)(iv) of IFRS 10

39. One respondent⁸ who agreed with the proposal suggested deleting paragraph 4(a)(iv) of IFRS 10, as follows:

... we request the IASB to reconsider the relevance of and the need for the criterion in paragraph 4(a)(iv) of the current standard more generally. It is not apparent to us why there should be a requirement that a parent entity of the

⁷ KPMG.

⁸ The South African Institute of Chartered Accountants (SAICA).

intermediate parent seeking to apply the exemption should be applying IFRS. We believe that it restricts, unnecessarily, the application of the exemption. For example, an intermediate parent may be a subsidiary of a parent company that does not apply IFRS, such as US Generally Accepted Accounting Practice, Australian Accounting Standards or IFRS as endorsed by the European Union. [SAICA]

Staff analysis and recommendation

40. We think that this request is beyond the scope of this narrow-scope amendment. We note that we have previously received a similar request and posted it on the website as *Pre-consultation planning—Agenda item requests*.⁹ The next formal agenda consultation is scheduled to be carried out in 2015.

Staff recommendation

41. On the basis of the analysis in the previous section of the paper, we recommend to the IASB that it should proceed with the proposed amendments to IFRS 10.
42. We also recommend to the IASB that it should make some changes to the proposed amendments to IFRS 10 and IFRS 12, as follows:
- (a) clarify in the transition requirement that the quantitative information required by paragraph 28(f) of IAS 8 is only required for the annual period immediately preceding the date of initial application of this IFRS;
 - (b) clarify the scope exemption by adding ‘, in accordance with paragraph 31 of this IFRS’ to the proposed paragraph 4(a)(iv) of IFRS 10 and to paragraph 17(d) of IAS 28; and

⁹ <http://www.ifrs.org/Current-Projects/IASB-Projects/IASB-agenda-consultation/Pages/Agenda-item-requests-2015.aspx>

- (c) clarify the applicability of IFRS 12 to investment entities that prepare separate financial statements as their only financial statements.

Question for the IASB

Question for the IASB

Does the IASB agree to proceed with the amendments to IFRS 10 and add further changes to IFRS 10 and IFRS 12?