THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

BY ELECTRONIC MAIL: jstevenson@osc.gov.on.ca

January 14, 2010

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission – Securities Division
Manitoba Securities Commission
Ontario Securities Commission
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Financial Services Regulation Division, Department of Government Services, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
M5H 3S8

Dear Mr. Stevenson:

Re: NI 81-106 Investment Fund Continuous Disclosure and Companion Policy

We are writing to provide the comments of the members of The Investment Funds Institute of Canada ("IFIC") on the Notice and Request for Comments dated October 16, 2009 on Proposed Amendments to National Instrument 81-106, *Investment Fund Continuous Disclosure* and Companion Policy 81-106CP *Investment Fund Continuous Disclosure* and Related Amendments published for public comment by the Canadian Securities Administrators ("CSA").

For the most part, IFIC is supportive of the proposed amendments. However, IFIC's members have identified one key area of concern with the proposed amendments, related to consolidation. The impact of these proposed reform measures, and IFIC's recommendations for amendments, both as they relate to consolidation as well as various less significant technical issues, are described below.

Consolidation

It is our understanding that the overarching principle of this reform is to provide meaningful financial statements for investors and other users of financial information. As discussed below, we do not believe that consolidation will help attain this goal. Further, we anticipate significant confusion on the part of retail investors reading the financial statements, exacerbated by many "lack of comparability" issues that we highlight below.

IFIC is writing to strongly urge that the securities regulators exercise their powers to mandate non-consolidation by investment funds. IFIC's view is that if this is not done, the amendments will create a pervasive problem across the mutual fund industry, as well as affect other funds subject to NI 81-106 and required to adopt International Financial Reporting Standards ("IFRS"), such as structured products, labour-sponsored investment funds, pooled funds, and others.

Background

The proposed amendments to the Instrument contemplate that investment funds will prepare and file consolidated financial statements (other than the statement of investment portfolio) if required by IFRS; the statement of investment portfolio will be prepared on a non-consolidated basis; the statement of investment portfolio will be audited; and the financial highlights in the Management Report of Fund Performance ("MRFP") will be presented on a non-consolidated basis.

Several years ago, accounting standards in Canada required the consolidation of investment funds which resulted in confusion by financial statement users as well as numerous operational issues incurred by the industry, prior to accounting standards being changed.

Currently in Canada, investment funds are generally exempt from the requirement to consolidate because of CICA Accounting Guideline 18 (AcG18). However, with the adoption of IFRS in Canada in 2011, AcG18 will be eliminated for publicly accountable entities.

Significance to the Industry

IFIC is very concerned that consolidation by investment funds will cause significant differences in financial reporting between similar types of investment funds, with the result that users of the financial statements will be confused by these differences. In addition, the operational challenges for the industry in preparing consolidated financial statements are distinctly different from other industries and are expected to cause excessive increases in complexity and costs, as we outline below.

Consolidation is expected to apply primarily to fund of fund and "corporate class" mutual funds, closed-end funds, pooled funds and hedge funds where the top fund owns more than 50% of the

underlying fund, and labour-sponsored funds and various other vehicles where the fund owns a control position in an operating entity. We estimate, based on current standards, that consolidation could impact a significant portion of the industry: approximately 992 funds with a value of $133 billion, which is 21% of all investment funds, excluding pooled funds and hedge funds [1](please see Appendix A for a more detailed breakdown), would be required to analyze and assess consolidation requirements for preparation of financial statements. It also is important to note that pooled funds and corporate class funds are the most rapidly growing classes of investment funds.

A fundamental principle of consolidation relates to the concept of control over the investee. For fund of fund products where the underlying funds themselves are also open-ended mutual funds, the top fund's ownership of the underlying fund can change daily not through its own actions but by virtue of the action of other investors' activities at the underlying fund level. This frequency of change and lack of involvement of the top fund investor in such change reflect the very different dynamics of the industry versus a typical corporate environment.

The following are the key challenges and operational issues uniquely facing investment funds regarding consolidation:

1. Fund of funds may consolidate in some periods and not in others. The percentage ownership of an open-ended fund changes every day as outlined above, but consolidation likely only will be required if the ownership percentage exceeds 50%. In situations where a top fund owns various underlying funds, the specific funds required to be consolidated may change from year to year. As a result, for example, an entity may own the same underlying fund at successive period ends but consolidate the holdings on the Statement of Financial Position at one period end and not the other.

   In addition, the decision to consolidate in a fund of funds situation is not expected to be a clear assessment, and qualitative factors may potentially play a significant role in the determination, depending on the existing or future consolidation standard (e.g., considering factors such as single largest holding or existence of related party holdings). This could lead to inconsistency between fund of funds within the industry, which would further reduce comparability and understanding by users.

2. The Statement of Operations for fund of funds will only consolidate for the period of time during which control existed. With investment funds carried at market, the percentage of ownership is constantly changing and may be above 50% for only a certain portion of the reporting period. Consolidation might be required, stopped, restarted, and

[1] As at December 31, 2008, Investor Economics estimated total assets for all investment funds was $621 billion, excluding pooled funds ($50 billion) and hedge funds ($14 billion).

then stopped for multiple periods throughout a year, with consolidation periods being as short as one day.

A key issue, as a result, will be the requirement for the fund to be able to track on a daily basis its ownership of each underlying fund in order to determine throughout the year whether consolidation is required for each and every investment. Such tracking systems and processes do not currently exist in the industry.

3. Where the underlying fund is not related to the top fund (as occurs in certain fund of fund complexes), the top fund's manager may not have access to the underlying fund's accounting records. This could significantly hinder financial statement preparation and potentially result in audit scope limitations.

4. If a fund owns an operating entity, consolidation will put non-fair valued assets and liabilities onto the balance sheet which could be accounted for on a different basis than the rest of the investment portfolio. It leads to more differences between pricing NAV and accounting NAV. Consolidation of an operating enterprise will result in separate disclosure of financial statement balance sheet items such as goodwill and capital assets and income statement items such as cost of goods sold, which NI 81-106 does not specifically address and which would confuse investors. The potential also exists that the operating entity could be a non-publicly accountable enterprise which will not adopt IFRS. This in turn would require the fund to convert the operating entity's financial statements into IFRS prior to consolidation.

5. We anticipate significant potential operational issues with timely access to information for consolidation purposes since the financial statements of top and bottom funds (as well as for operating enterprises) may be prepared concurrently. This is exacerbated due to the fact that determination of which underlying entity needs to provide information and for what period will continue to change right up to the year end of the fund.

6. There is an issue with non-coterminous year-ends, since financial statements may not be prepared to match the consolidating fund's year end (for example, a November year-end fund consolidating a September year-end fund). To address this scenario, additional resources within a fund company's finance department may be required. This also could result in additional audit costs as the stub period would likely be unaudited, hence requiring additional work to be performed for purposes of the audited consolidated financial statements. What makes this a unique issue for the investment funds industry is that the requirement to consolidate a non-coterminous underlying fund may not be known until the year end of the top fund due to the ever-changing ownership interests of the underlying fund.

7. Combining some non-consolidated information into a consolidated set of financial statements: these financial statements may not be in conformity with IFRS which could prevent a "clean" audit opinion.

8. Existing finance departments at fund companies (and service providers to the industry) are currently not structured to deal with consolidation requirements. As noted above, the many and significant issues will require systems, processes and substantive additional resources to enable the industry to prepare consolidated financial statements.

9. Filing timelines – we believe that existing 60 and 90 day filing requirements for investment fund financial statements would not be sufficient to enable preparers to produce consolidated financial statements given the issues noted above. Extensions would likely need to be required annually and the level of complexity of the fund (at each reporting period) could significantly impact the extent of additional time required.

10. Consolidation of underlying entity operating revenues and expenses into the Statement of Comprehensive Income will have significant implications to the MRFP disclosures of the per share tables and MER/TER disclosures. With no guidance, there is a high potential for inconsistent application, particularly as it relates to the calculation of MER.

These operational challenges are expected to have a significant impact on the ability of a reporting issuer to produce financial statements in a timely manner, particularly in regard to the financial statement filing timeline requirements. Furthermore, the additional costs of preparing this information to ensure that it is both accurate and that it can be audited have the potential to far outweigh any benefit expected to be achieved.

Currently, the International Accounting Standards Board is re-evaluating the IFRS consolidation standard and IFIC has made representations to them[2]; however the development of a new IFRS consolidation standard is probably at least a year away. In the interim, we ask that the CSA exercise its powers and mandate that investment funds be required to file only non-consolidated statements with regulators. Furthermore, we recommend that the Statement of Investment Portfolio (SOI) be required to be provided as a "supplementary schedule" or in the notes to the financial statements rather than as a standalone statement. This is likely to be most conducive to managing auditors' concerns with being able to provide an unqualified opinion in accordance with GAAP. As a result, we recommend changing the terminology from "Statement" to "Schedule".

[2] Attached at the end of the submission is a copy of IFIC's submission to the IASB on the issue of consolidation.

In support of this recommendation are the findings of a December 2009 survey that IFIC conducted of its members to determine their views on consolidation under IFRS[3]. Approximately 40 responses to the survey question were received, and all respondents unanimously selected the option that both the financial statements and the statement of investments be prepared on a non-consolidated basis.

We also would point out the results of an IASB/CICA-sponsored Canadian investment fund users call held in September 2009. Canadian investment fund users chosen included institutional and retail investors, analysts, the media and regulators. On this call, the users were unanimous in their view that they were looking for fair value information of investments held by an investment fund and that little or no value was provided by consolidation. Staff of the IASB told us that this view was similar to that expressed by users in other jurisdictions.

Cost / benefit analysis

We remain concerned that the anticipated additional costs of consolidation have not been taken fully into account. To determine the anticipated costs of adopting IFRS, the Notice refers readers to the materials proposing amendments to NI 52-107. There, the CSA notes that: "While the changeover to IFRS may impose costs on our market participants, the changes in the Proposed Materials are generally expected to not impose additional costs and may even assist in reducing costs of the transition by providing appropriate guidance and increasing awareness of the changeover".

Under clause 143.2(2)7 of the Ontario *Securities Act,* a description of the anticipated costs and benefits of a proposed rule are to be published with the notice of every proposed rule. We do not believe that the Notice meets this statutory requirement.

As described above, the additional costs related to implementation of consolidation result from the need for increased levels of resources:

- potential additional reviews by the outside auditors;
- additional resources needed to monitor when the 50% threshold is crossed - additional staff will be required in finance departments for this and other functions;

[3] Excerpt from IFIC survey: There are three basic options with respect to the CSA's requirements on consolidation as follows:

1. Prepare both the financial statements and the statement of investments on a consolidated basis
2. Prepare the financial statements on a consolidated basis but prepare the statement of investments on a non-consolidated basis (proposed in the changes to NI 81-106)
3. Prepare both the financial statements and the statement of investments on a non-consolidated basis

We ask that you help us with our recommendations by providing us feedback on which option you think would provide the best information to investors.

- due to the added complexity of the required information, system enhancements will be required, which involve a cost to develop and maintain;
- where the top funds and bottom funds have different managers, the top fund manager will be required to expend additional resources to coordinate consolidation with the bottom fund manager; and
- similarly, the manager of the bottom fund will be required to commit additional resources to coordinate consolidation with top fund managers.

All these costs are ultimately borne by investors, and do not appear to have been considered by the CSA in this Notice. While these costs are very difficult to assess at this stage due to the number of uncertainties involved, it is not inconceivable that this could result in a doubling or more of operating expenses (excluding the management fee expense) for certain funds.

Precedent

Securities regulators in Canada have for many years required the financial statements filed by registrants to be prepared on a non-consolidated basis. National Instrument 31-103 continued this treatment and the amendments proposed to NI 52-107 will require Canadian registrants to file their audited annual financial statements with the applicable CSA members in accordance with Canadian GAAP, but on a non-consolidated basis. The CSA accordingly has precedent for non-consolidation reporting already for certain registrants where non-consolidated financial statements are required for the purposes of determining capital requirements (though we recognize that this is not for general purpose statements). Such a basis of accounting as required by regulation would allow a "clean" audit opinion and be less confusing for investors.

We also would point out that securities regulators in other countries appear to be considering whether investment funds should consolidate and in fact whether non-listed funds should even adopt IFRS. There also is precedent in other jurisdictions for alternative fair presentation frameworks for general purpose financial statements, Some of these are based on a modified version of IFRS and have been referred to as "IFRS as adopted in [jurisdiction]" or defined as an "IFRS except for […]" framework. We strongly urge the CSA to consider this alternative approach to mandate non-consolidation by investment funds. We further would note that the new audit reporting model in Canada, resulting from the Canadian adoption of International Auditing Standards, provides for alternative fair presentation frameworks and does not specifically endorse pure IFRS over other fair presentation frameworks. We believe that it is up to the securities regulators in each jurisdiction to determine the most appropriate financial reporting framework that produces relevant and comparable financial information for investors. A "one-size-fits-all" approach to financial reporting by investment funds in Canada does not accomplish this objective.

Questions Posed by the CSA

Please see Appendix B for IFIC's responses to the specific questions raised by the CSA.

Classification of Investment Fund Securities (Puttable Instruments)

As noted in the summary of the proposed amendments, currently NI 81-106 contemplates that the securities issued by investment funds are usually classified as equity. The proposed amendments alter some of the line items in the financial statements to accommodate either an equity or liability presentation. The CSA has requested feedback on its approach to the treatment of the classification of securities issued by investment funds.

We note the following issues that have been raised respecting the amendments to accommodate puttable instruments:

Clause 3.2 Statement of Comprehensive Income. We note that NI 81-106 does not prescribe whether its use is by a nature or by a function format. This in turn leaves it open to significant divergence in presentation, which is contrary to the IFRS stated goal of comparability.

> **Item 15 Net investment income or loss for the period** Net investment income is not defined. It could be – and already is – different from fund to fund (for example, with respect to placement of transaction costs). We recommend a definition be prescribed or the item be repealed.
>
> **Item 17.1 Distributions** We recommend that item 17.1 follow item 18, with corresponding renumbering.
>
> Return of capital is noted in this item, but we believe that it should be cited on the Statement of Changes, not as a distribution of income. We further question how fee rebates distributed as capital are to be treated.
>
> For funds with liability treatment, there should be a subtotal after distributions to reconcile the amounts with its corresponding line on the statement of changes (the increase / decrease attributable to security holders from operations after distributions).
>
> Are the distributions per series or in total?
>
> **Item 19 Increase or decrease in total equity from operations per security** We recommend that this line item be removed as it is not a required disclosure for a non-listed investment fund under Canadian GAAP or IFRS and could be considered a non-GAAP earnings measure because of the classification of investor equity as a liability, which may cause audit issues.

Section 3.3 Statement of Changes in Financial Position

Item 2 Repealed: increase or decrease in net assets from operations. With the repeal of item 2, the statement will not balance. We recommend that the subtotal mentioned under item 17.1 be included here.

Item 4 aggregate amounts paid on redemption of securities of the investment fund With respect to the reference to redemption of securities, we note that for funds using equity treatment, the value presented on the statement of changes could potentially be bifurcated between share capital (cost) and retained earnings.

Section 3.7 Inapplicable Line Items We recommend that the phrase "for which the investment fund has nothing to disclose" be replaced with either the phrase "is insignificant to the financial statements" or "is immaterial to the financial statements".

Suggestion: The current rules allow for two different presentation styles – equity or liability methodology. We suggest as an alternative that consideration be given to requiring a single format for presentation of financial information to users, given that two different presentation styles somewhat reduces comparability and may result in confusion to users. We note that most funds would present their financial information on the basis of the liability methodology.

Part 15 Calculation of Management Expense Ratio The MER change deals with the additional impact of distributions as an additional expense. However, under IFRS, there may be other changes on the income statement that drive items into gross presentation rather than net. In addition to the concerns raised above with respect to MER calculations where consolidation has been applied, a further example might be a real property fund where specific property-related expenses are netted against rental revenue in the presentation. Accordingly, property-related expenses are not included in the "total expense" line and are not added to the MER. We believe that presentation changes should not result in an increase in the MER figure.

Additional Considerations

Clause 2.1(1)(f)(iii) Under the proposed revision, an investment fund must file annual financial statements for the investment fund's most recently completed financial year that include a statement of financial position as at the beginning of the immediately preceding financial year if the investment fund discloses in its annual financial statements an explicit and unreserved statement of compliance with IFRS and if the investment fund reclassifies items in its annual financial statements.

We note that reclassification of items requires inclusion of the opening statement of the financial position for the comparative period – this appears excessive unless there is a qualification that exempts minor or immaterial reclassifications from this requirement (for example, minor changes in income statement expense groupings or balance sheet groupings).

Subsection 3.5 Statement of Investment Portfolio The provision requires that if an investment fund discloses the short term debt instruments, the investment fund must disclose separately the aggregate short term debt instruments denominated in any currency if the aggregate exceeds 5% of the total short term debt. We recommend this subsection be repealed since Section 3862 of the CICA Handbook (IFRS 7) adequately addresses currency risk in financial instruments.

Transition We strongly urge that an automatic one-time 30 day extension be provided for both the first interim and the annual reports under IFRS. Such a transition period will be essential to permit time to accommodate the various IFRS changes required to the financial statements of a fund. We anticipate a significant amount of additional preparation time will be required for all funds in preparing a statement of cash flows (previously not required for substantially all mutual funds governed by NI 81-102), as well as the terminology changes, reclassifications, opening balance sheet disclosures and all the related French translation changes required.

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Thank you for providing us with an opportunity to comment. If you have any questions regarding this submission, please contact me directly by phone at 416-309-2300 or by email at jdelaurentiis@ific.ca or John Parker, Vice President Finance and CFO by phone at 416-309-2319 or by email at jparker@ific.ca.

Yours very truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Joanne De Laurentiis
President & Chief Executive Officer

APPENDIX A

Potential Impact of Consolidation

	Assets ($Billion)	# Funds	Average Assets ($Millions)	Median Assets ($Millions)
Mutual funds				
- Fund-of-funds *	93	411	226	46
- Corporate class funds *	31	481	64	21
LSIFs	3	30***	N/A	N/A
Closed end funds	6	70	84**	39**

TOTAL******	133	992

* Based on IFIC statistics
**Investor Economics – *Household Balance Sheet 2009*
*** This figure illustrates the number of instances where consolidation would be required, rather than the total number of LSIFs.
**** In addition to the funds included in the table, a number of pooled and hedge funds will be impacted. There are approximately $64 billion in pooled and hedge fund assets in Canada (Investor Economics), however the impact of consolidation on these assets is not easily determinable.

All data at December 31, 2008

Appendix B

Classification of Investment Fund Securities (Puttable Instruments)

The CSA is seeking feedback on its approach to the treatment of the classification of securities issued by investment funds.

Please see the submission for IFIC's detailed comments.

The proposed amendments to the Instrument contemplate that:

- **investment funds will prepare and file consolidated financial statements (other than the statement of investment portfolio), if required by IFRS**
- **the statement of investment portfolio will be prepared on a non-consolidated basis**
- **the statement of investment portfolio will be audited**
- **the financial highlights in the management reports of fund performance will be presented on a nonconsolidated basis.**

The CSA is seeking feedback on this approach to consolidation for investment funds. We would like specific information about the impact of consolidation on Canadian investment funds, including your analysis and determination of how this standard will be applied and the consequences to the presentation of the financial statements.

We also invite focused comments on the ability of investment funds to prepare the statement of investment portfolio on a nonconsolidated basis, and to have this statement audited in accordance with Canadian GAAS using a fair presentation framework. In addition, will the proposed requirement to explain differences between the statement of investment portfolio and the statement of financial position result in useful disclosure about the relationship between these two statements? If not, would a numerical reconciliation achieve this result?

Please see IFIC's earlier comments on the proposed approach to consolidation.

We note that there is no issue with preparing the statement on a non-consolidated basis and its ability to be audited in accordance with Canadian GAAS, but there is an expectation that the audit firms will not be able to audit this as a "Statement". A potential solution is to have the information called a "Schedule of Investments" included as part of the notes to the financial statements.

The requirement to consolidate could result in additional differences between net assets (as shown on the financial statements) and net asset value, which could impact the reconciliation of these amounts required to be disclosed in the notes to the financial statements. Please consider whether this will result in any additional presentation issues.

We expect that there will be additional presentation issues of potentially great significance. An example of this would be the need to add in a significant number of accounting policies related to items such as business combinations, goodwill and intangible assets, stock compensation, pension accounting, and lease accounting, to name only a few, for those funds that own operating entities. These disclosures would be necessary in order to be able to articulate the basis of accounting of the various assets and liabilities brought on balance sheet by the consolidation process, since it differs from their fair value accounting, in order to assist in explaining the reconciliation.

As the statement of investment portfolio is not one of the financial statements listed in the complete set of financial statements in IAS 1 Presentation of Financial Statements, please provide your views on whether it can be audited as part of annual financial statements audited in accordance with Canadian GAAS using a fair presentation framework.

Please see above regarding the ability of the statement of investment portfolio to be audited.

If not, can disclosure equivalent to the disclosure currently provided in the statement of investment portfolio be instead provided in the notes to the financial statements or in an audited supplementary schedule?

Yes, IFIC believes that this is likely the most workable solution if this is required to be presented on a non-consolidated basis. The accounting firms will provide input on how that would be auditable.

THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

4 September 2009

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

RE: ED 10, Consolidated Financial Statements

The Investment Funds Institute of Canada ("IFIC") and bcIMC appreciate the opportunity to provide additional comments on Exposure Draft 10, *Consolidated Financial Statements* ("ED 10"). We are responding to issues raised at the June 2009, round table meeting on investment management held in Toronto, Canada.

In our comment letter on ED 10, and subsequently at our meeting, we articulated that circumstances exist where fair value measurement provides the most relevant information about an investment that is managed on a fair value basis, irrespective of whether control exists. At the round table, we were asked to develop and propose a solution that would appropriately circumscribe these cases and that would fit within the constraints of ED 10 as drafted.

We considered various investment activities and the characteristics that distinguish those activities in circumstances where we think fair value is most relevant. Our conclusion is that fair value is most relevant when the investment is managed, and its performance is measured, on a fair value basis. In these circumstances, users focus on fair value in evaluating the success of the reporting entity in managing its investment. Consequently, our proposal is based on the notion that fair value provides the most relevant information to users of financial statements when an investment in a subsidiary is managed on a fair value basis. Therefore, we have suggested amendments that we think would accomplish the objective of circumscribing those circumstances.

We also examined the guidance in ED 10 about agency relationships and considered whether the responsibilities of an investment entity would preclude control based on the proposed guidance in ED 10. As a result, we determined that we think circumstances exist in which an entity may be precluded from having power to direct the activities of another entity due to regulatory, contractual or other legal restrictions. We think that it would be useful to clarify the guidance in ED 10 on this point. However, we also think that it is not likely to address all circumstances in which fair value is the most relevant basis of accounting for financial interests held in another entity.

We are conscious of your concerns that any proposals need to be defined in such a manner to prevent inappropriate use. We think that we have provided sufficient guidance to achieve that objective, as illustrated by the application examples in the Appendix.

If you have any questions, or would like to further discuss our proposals, please do not hesitate to contact Joanne De Laurentiis at jdelaurentiis@ific.ca.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

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Chair, IFIC Accounting Advisory Working Group

Project	**Consolidation**
Topic	**Investments managed, and for which performance is evaluated, on a fair value basis**

Introduction

1. The purpose of this paper is to propose that investments in subsidiaries that are managed, and for which performance is evaluated, on a fair value basis be measured at fair value, irrespective of whether control exists.
2. We acknowledge that this is an exception to the core principle in paragraph 1 of ED 10, *Consolidated Financial Statements.* However, we think that fair value measurement provides the most relevant information to users of financial statements in these circumstances.
3. This paper:
   (a) explains why fair value provides the most relevant information for users in these circumstances;
   (b) discusses comments received in response to ED 10 relating to investments that are managed, and for which performance is evaluated, on a fair value basis;
   (c) considers other IFRS precedents;
   (d) proposes a core principle;
   (e) defines what is meant by "managed on a fair value basis";

(f) provides factors and characteristics that should be considered when determining whether an investment in a subsidiary is managed, and its performance is evaluated, on a fair value basis;

(g) considers the advantages of an approach that focuses on a reporting entity's activities in relation to its investments as opposed to one that focuses on the investment itself;

(h) proposes reporting standards for accounting for investments by parent company and equity method investors in entities that manage and evaluate performance of investments on a fair value basis;

(i) discusses disclosures that may be included in circumstances where subsidiaries are accounted for at fair; and

(j) discusses circumstances in which regulations, contracts or other legal restrictions have the substantive effect of eliminating or offsetting the power that a reporting entity might otherwise have as a result of its investment.

4. The Appendix to this paper applies the proposed guidance to examples of common investment structures to demonstrate that the exception provides a practical and meaningful basis only for those investments that are managed, and for which performance is evaluated, on a fair value basis.

Fair value is most relevant for investors when investments are managed, and performance is measured, on a fair value basis

5. In the Reporting Entity phase (phase D) of the conceptual framework project, the Board confirmed its view that consolidated financial statements, in which entities are consolidated on the basis of control, are most likely to provide decision-useful information to the greatest number of capital providers. While most likely, it is not always the case.
6. The ability to provide decision-useful information is important since the objective of financial statements in the Framework is to provide information that is useful to a wide range of users in making economic decisions [paragraph 12]. This is only achieved to the extent that such information is relevant [paragraph 25], which results when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations [paragraph 26]. It follows that controlled investments should not be consolidated when consolidation does not result in relevant, decision-useful information to users.
7. Financial statement users and regulators have consistently asserted, through comment letters and commentary about accounting for investments by certain types of entities, that consolidation is not relevant when a reporting entity is holding an investment for capital appreciation, the receipt of current income, or both and is prepared to realize the fair value of that investment to satisfy existing obligations to stakeholders. Acceptance of this view is evidenced by the wide-spread use of fair value in accounting for such investments by investment entities around the world. Often, this argument is presented in the context of investment entities that issue

redeemable units or shares, such that the entity must be prepared to realize the fair value of its assets through sale in order to satisfy its obligations. In many cases, private equity and similar organizations are privately-held and the investors in such entities represent the primary, or only, financial statement users. Additionally, information about the fair value of investments is often requested by and provided to investors in these types of entities, in conjunction with the financial statements, or more frequently.

8. For entities whose primary business purpose is to acquire investments for capital appreciation, current income, or both, value realization occurs as a result of holding an investment, rather than from managing the underlying assets and operations of an investee. Investments held by such entities are like a portfolio of financial instruments held for trading by a financial institution, or investment property held by an entity for capital appreciation, current income, or both. Investing activities by traditional operating entities differs in that they involve activities other than holding the investment (e.g., managing the activities of the investee and its underlying assets to maximize cash flows of the consolidated entity).
9. Users of financial statements for these entities need to understand the cash flows and changes in the fair values of its investments, including subsidiaries acquired only for investment purposes, in order to understand the performance and financial condition of the entity. This results from the fact that the entity's primary objective is to maximize the fair values of its investments, which are also the means by which financial statements users measure the entity's success in meeting that objective. While the investee's individual assets and operations are ultimately the

source of changes in its fair value, consolidated financial statements would preclude recognition of the full changes in fair value since certain items (e.g., goodwill, some types of intangibles and deferred taxes) cannot be measured at fair value in the consolidated financial statements under existing standards. Additionally, consolidation obscures the users' ability to assess the reporting entity's financial position and results as it emphasizes the financial position, operations and cash flows of the investee, rather than the financial position, operations and cash flows of the reporting entity.

10. Consolidating these investments also reduces users' ability to compare the different investments reported in the reporting entity's financial statements, as well as the investments held by different reporting entities of a similar nature. Commonly, these reporting entities will also hold non-controlling interests in other entities that are reported at fair value. Reporting controlling interests and non-controlling interests in other entities on a different basis hinders the ability of users to compare investments, despite the fact that the investments are both managed and evaluated on a fair value basis. Accounting for investments consistently and lack of comparability between investments and entities, will affect users' capital allocation decisions.

Comments received in response to ED 10

11. Comments received in response to ED 10 as it relates to investments managed, and for which performance is evaluated, on a fair value basis focused primarily on the nature and characteristics of the reporting entity, rather than the reporting entity's business purpose and activities associated with the specific investment.

For example, many responses referred to investment companies (e.g., mutual funds, venture capital and other similar organizations) that often manage investments and measure and report performance on a fair value basis. We think that other entities not within this group may also manage particular investments on a fair value basis. We acknowledge that the Board prefers not to develop standards that centre on specific types of reporting entities. Therefore, we think that guidance intended to apply to all circumstances in which fair value is most relevant would therefore need to focus on the activities of the reporting entity in respect of the investment, rather than on the nature and characteristics of the reporting entity.

12. Respondents also noted that financial reporting requirements exist in other reporting frameworks around the world that require specified entities to account for controlled investments at fair value. For example, they noted that the AICPA Audit and Accounting Guide: *Investment Companies* and SOP *07-01, Clarification of the Scope of the Audit and Accounting Guide "Investment Companies" and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies,* issued by the American Institute of Certified Public Accountants in the U.S. and Accounting Guideline 18, *Investment Companies*, issued by the Canadian Accounting Standards Board ("the AcSB") require fair value accounting for investments held by investment companies in all but remote circumstances. Additionally, the AcSB recently issued an exposure draft on accounting by pension plans, in which it proposed that such entities would not consolidate investments. Recently, the

Accounting Standards Board in the U.K. proposed similar guidance in its Discussion Paper *The Financial Reporting of Pensions,* as did the Australian Accounting Standards Board in its Exposure Draft, *Superannuation Plans and Approved Deposit Funds*.

13. Some respondents also noted that similar principles already exist in IFRS. For example, they noted that in IAS 28, *Investments in Associates,* the Board confirmed its view that equity or proportionate consolidation methods of accounting for investments held by venture capital organizations, mutual funds, unit trusts and similar entities often produces information that is not relevant to their management and investors and that fair value measurement produces more relevant information [paragraph BC5]. Therefore, these respondents think that the issue is whether an effective method to make this principle operational can be developed for subsidiaries (i.e., not whether the principle is valid).

Other IFRS precedents

14. To provide more relevant information to users, IAS 39 also permits an entity to designate upon initial recognition financial instruments at fair value when:

> "a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel" (paragraph 9, definition of financial asset or a financial liability at fair value through profit or loss (b)(ii)).

15. In the Exposure Draft on "Financial Instruments: Classification and Measurement" issued in July 2009, the opposite approach has been proposed. To identify which financial assets or financial liabilities need not be reported at fair value, one of the required conditions specifies that "the instrument is managed on a contractual yield basis" (paragraph 4(b)). The proposed application guidance requires that those instruments "are managed, and their performance evaluated by the entity's key management personnel, on the basis of contractual cash flows that are generated when held or issued" (paragraph B1). As a result, users will be able to understand how an entity manages these financial instruments and evaluate management's performance on that basis.
16. Similarly, IAS 40, *Investment Property,* requires that a reporting entity account for its investment in property that is held to earn rentals, capital appreciation, or both, at fair value. The guidance in IAS 40 recognizes that the characteristics of investment property differ significantly from those of owner-occupied property, even when the reporting entity earns rentals from the property.
17. These precedents emphasise the importance of permitting similar items to be reported on different basis when an entity manages items on different basis in order to provide decision-useful information to users.

Proposed core principle

18. A reporting entity presents financial statements that consolidate its assets, liabilities, equity, income, expenses, and cash flows with those of the entities

that it controls, except for investments in entities that meet both of the following criteria:

(a) the entity manages the investment on a fair value basis; and

(b) the entity evaluates performance of the investment on a fair value basis, in accordance with a documented risk management or investment strategy and information is provided internally, externally, or both, on that basis to the reporting entity's key management personnel and other users [paragraph 1].

Investments managed on a fair value basis

19. An investment in a subsidiary is managed on a fair value basis when the reporting entity is holding the investment only for capital appreciation, receipt of current income, or both and is prepared to realize the fair value of that investment to satisfy existing obligations to stakeholders.

Factors that should be considered when determining whether an investment in a subsidiary is managed, and its performance is evaluated, on a fair value basis

20. The determination of whether a subsidiary is managed on a fair value basis is based on facts and circumstances specific to the reporting entity, its subsidiary and the relationship between the two. However, the following factors should be taken into consideration (the absence of one or more factors may not necessarily preclude an investment from being managed on a fair value basis):

a. the reporting entity is not, and has not been, involved in the day-to-day operations of the investee;

b. the reporting entity does not obtain, and has not obtained, benefits from the investee that would be unavailable to non-investors that hold non-controlling interests in the investee and are independent (i.e. they are not related parties);

c. The reporting entity is required, due to contractual, regulatory or other legal requirements, to report information about the fair value of the investment to its external investors;

d. A major component of compensation arrangements with management, including a portfolio manager, is based on the fair value of the investment;

e. Key performance metrics and internal reports are based on the fair value of the investment;

f. Personnel, information systems and other critical resources of the investee are and have been separate from those of the reporting entity (e.g., the reporting entity has not imposed its own personnel, information systems or other critical resources, including significant intercompany balances, on the investee for ease of operation and reporting);

g. The reporting entity is prepared to realize the fair value of its investments, since:

i. restrictions exist that limit the reporting entity's ability to change its stated purpose of managing investments on a fair value basis;

ii. the amount at which securities issued by the reporting entity are redeemed is based on the fair value of the net assets of the entity; or

iii. has specified a date subsequent to which the investment cannot continue to be held by the reporting entity.

Advantages of evaluating the criteria at the reporting entity level

21. We think that the advantages of evaluating the criteria at the level of the reporting entity's activities in relation to its investments outweigh those of evaluating them at the investment level for the reasons outlined below.

22. *It lessens the incentive and opportunity for abusive structuring*. Evaluating the criteria at the reporting entity level lessens the incentive for potential abusive structuring by requiring an enterprise meeting the criteria to account for all controlled investments at fair value. For example, if the evaluation is performed at the investment level, depending on the criteria, there may be opportunity for an enterprise to include non-substantive terms so that only well-performing investments meet the established criteria for fair value accounting. There would be less incentive to include such terms if all investments (both well-performing and poorly-performing investments) were required to be accounted for at fair value if the reporting entity as a whole meets the established criteria.

23. *It provides more meaningful financial reporting from a user's perspective*. Accounting for some investments at fair value and consolidating others may not provide a clear picture of the true performance of the enterprise as a whole and may be confusing for users. Investors and other users of financial statements of these types of entities evaluate performance based on fair value and management compensation is driven based on fair value. Financial statements

that include only selected investments at fair value would not portray the true performance of the enterprise as a whole.

24. *It reduces complexity and cost associated with accounting subsequent to initial recognition*. These entities often hold large inventories of investments and therefore, it would be very costly for them to evaluate whether each investment meets the criteria at each reporting date, rather than evaluating the enterprise as a whole.

25. *It is consistent with current requirements under U.S. GAAP and Canadian GAAP*. Evaluating the criteria at the reporting entity level is consistent with existing requirements under U.S. GAAP and Canadian GAAP which provide exceptions for reporting entities that manage, and measure performance, on a fair value basis. In evaluating whether an enterprise should is an entity that should account for controlled investments at fair value, the criteria in the AICPA Audit and Accounting Guide: *Investment Companies* and Accounting Guideline 18, *Investment Companies*, is applied to the reporting entity. A consistent approach under IFRS would reduce complexity and conversion costs for those enterprises that currently apply those standards and will transition to IFRS.

26. *It addresses the SEC's concern about lack of guidance for some entities that manageme, and evaluate performance of, investments on a fair value basis*. In the SEC's proposed IFRS roadmap, it excluded investment companies because of the lack of specific guidance under IFRS. Evaluating the criteria at the reporting entity level is consistent with the current requirements under U.S.

GAAP and would facilitate the SEC "scoping in" investment companies in a future roadmap. It would be unfortunate if a large number of US and possibly Canadian companies would not be able to adopt IFRS because it did not address accounting by these entities.

Advantages of evaluating the criteria at the investment level

27. *It would be consistent with IASB's approach to other standards*. Evaluating the investment company criteria at the reporting entity level would be inconsistent with the IASB's approach of not providing specialized industry guidance that reaches across all transactions of an enterprise in a specific industry. Rather, the IASB prefers to develop guidance that is applied to specific transactions. By including criteria that focuses on the reporting entity, the Board would essentially scope out entire enterprises from the consolidation standard rather than individual investments.

28. *It is consistent with how entities are managed*. Management generally evaluates each investment separately in determining how to allocate resources to their different investments and ultimately whether to hold or dispose of an investment. Therefore, financial reporting based on assessments made at the individual investment level would reflect how management views and manages investments.

Accounting by parent company and equity method investors for investments in entities that manage, and evaluate performance, of investments on a fair value basis

29. The previous section of this paper discussed the advantages of using an approach that focuses on the reporting entity versus an approach that focuses on the individual investment. If an approach is developed that focuses on the activities of a reporting entity in relation to its investments, circumstances may arise where an ultimate parent company controls a reporting entity that carries its investment in another controlled subsidiary at fair value. Therefore, the question arises as to whether or not fair value accounting should be retained by the ultimate parent company. We propose the following guidance, adapted from Accounting Guideline 18, to address such circumstances:
30. The parent company of, or equity method investor in, another entity that manages and evaluates performance of its controlled subsidiaries on a fair value basis, and that accounts for those investments at fair value, should account for that other entity's investments at fair value only if each of the following apply:
    (a) the immediate subsidiary or affiliate entity is a separate legal entity whose primary business activity for the period is to hold investments for the purpose of capital appreciation, current income, or both;
    (b) the parent company or equity method investor is not involved in the day-to-day management of the investees;
    (c) the parent company or equity method investor does not obtain benefits that are unavailable to non-investor entities that are not related parties of the investee; and

(d) the parent company and its subsidiaries follow established policies that effectively distinguish the nature and type of investments made by the immediate subsidiary or affiliate entity from those made by other entities within the group that do not manage and evaluate performance of investments on a fair value basis. These policies prohibit subsidiaries that manage and evaluate performance of their investments on a fair value basis from making investments that are similar to investments held by the parent company, or another member of the consolidated group, and that are accounted for by the equity method or by consolidation.

31. If all of the conditions (a) – (d) are not met, the ultimate parent company or equity method investor should consolidate investments held by investees that manage, and evaluate performance of, investments on a fair value basis.

Disclosures required when investments are reported at fair value

32. We think that in circumstances where subsidiaries are managed, and their performance is measured, on a fair value basis, it may be useful for a reporting entity to provide additional disclosures in its financial statements that provide information about the subsidiary. Due consideration will need to be given to the cost and benefit associated with additional disclosures, and to determine which disclosures would be appropriate to mandate will ultimately require consultation with users of financial statements for these types of entities.

33. We have adapted the disclosures below from Accounting Guideline 18, which we think provides a good starting point from which required disclosures can be developed.

34. A reporting entity should disclose:

    (a) that its investments are measured and reported at fair value, including those that meet the definition of a subsidiary and those over which the investment company exercises significant influence (identifying any exceptions as outlined in the prior section);

    (b) the method adopted to determine fair value and any significant assumptions made[1]; and

    (c) the maximum exposure to loss and the nature of the exposure, including the risks that could give rise to that loss, when the maximum exposure to loss for any investment is greater than the carrying amount of the investment.

35. Additional disclosures that would provide further insight into the financial position, operations and cash flows of the other entities that the reporting entity holds a controlling interest in have not been proposed. Based on reporting experience in North America, such information has not been needed. Users have been making capital allocation decisions based on fair value information described above. As a result, the cost of providing information about the underlying activities of each controlled investee may outweigh its benefits.

[1] Once issued, this requirement should be revised to refer to the IASB's proposed standard on Fair Value Measurement.

36. If an approach is developed that focuses on the activities of a reporting entity in relation to its investments, the following additional disclosures should be required. When in the financial statements of the parent company, or equity method investor investments are reported at fair value, those statements should disclose information necessary to understand the extent to which enterprises that are controlled by the reporting entity or over which it is able to exercise significant influence, are reported at fair value, including, at a minimum:
    (a) the investments held by a subsidiary that carries its investment in another controlled subsidiary at fair value;
    (b) the carrying amount of the interest in the subsidiary that carries its investment in another controlled subsidiary at fair value and the caption in the balance sheet that it is included in;
    (c) the name of any investee of the subsidiary that carries its investment in another controlled subsidiary at fair value that the parent company controls as a result of its interest in that subsidiary;
    (d) the parent company's percentage ownership in the investee; and
    (e) the maximum disclosures to loss describe above.
37. When the accounting by a subsidiary of carrying its investment in another controlled subsidiary at fair value is retained in the financial statements of the parent company, those statements should disclose information necessary to understand the impact on the parent company financial statements, including, at a minimum:

(a) the gross unrealized gains and losses on investments held by the subsidiary at the balance sheet date;

(b) the net realized gains and losses and the net unrealized gains and losses for each year; and

(c) the policy for distinguishing the nature and type of investments made by the subsidiary from investments made by other members of the consolidated group.

Regulations, contracts or other legal restrictions that limit power

38. We considered whether it was possible to address circumstances where fair value is most relevant by including additional guidance or interpretations of the basic principles in ED 10 about control. For example, we considered whether regulations, contracts or other legal restrictions have the substantive effect of eliminating or offsetting the power that a reporting entity might otherwise have as a result of its investment. We think that it is useful to include such guidance, however; it is unlikely to address the circumstances described above since such circumstances may exist irrespective of whether or not control exists.

39. We recommend that additional guidance be included in the proposed consolidation standard to clarify that a reporting entity does not have the power to direct the activities of another entity, and therefore does not control that other entity, when the reporting entity has:

    (a) an irrevocable and enforceable promise to third parties not to direct the activities of that other entity; or

(b) is prevented by regulation or law of having or exercising its power to direct the activities of that other entity.

Appendix – application of the proposed model

A1. The first and second of the following examples illustrate situations in which an investment is managed, and its performance is evaluated, on a fair value basis and the third and forth examples illustrate situations in which an investment is not managed on a fair value basis. The fifth example illustrates the application of the additional guidance proposed for the accounting by a parent company for entities that manage and evaluate performance of investments on a fair value basis.

Example 1 – mutual fund that controls another entity

Fact pattern

A2. Entity A is an open-ended mutual fund trust (i.e., an investment vehicle that allows investors to join or exit the entity at any time, based on the fair value of the entity's net assets) that holds global equity investments, including 35% of the outstanding equity of Entity B. Entity A's offering document that is provided to investors stipulates that it has no operations, other than to hold global equity investments. Entity A's investors can withdraw from the fund at any time, based on the fair value of the entity's net assets, which is reported daily. Management of EntityA are compensated based on 2% of its net assets, calculated daily based on the fair values of its assets and liabilities. Entity B is a tire manufacturer and recent market events caused Entity B's shares to trade at a price that Entity A thought was a deep discount to their longer-term value, resulting in Entity A's 35% acquisition. The remaining shareholders of Entity B are widely disbursed and Entity A is the dominant shareholder.

Analysis

A3. As the remaining shareholdings are widely dispersed, Entity A is a dominant shareholder and controls Entity B. Entity A is not involved with the day-to-day operations of Entity B because Entity A has not replaced or does not have any management in common with Entity B. Also, Entity A is entitled to receive dividends and other capital distributions from Entity B, but does not obtain any other benefits from Entity B that would be unavailable to independent non-controlling investors of Entity B. Investors in Entity A are able to withdraw from the fund based on the fair value of the net assets, which evidences the focus of the entity and its investors on the fair value of its net assets, including the investment in Entity B. Entity A compensates its management and calculates net assets daily, based on the fair value of its investments. Entity A is also restricted in its ability to continue to hold the investment in Entity B, due to the redeemable nature of its units as an open-ended mutual fund trust. Therefore, we would conclude that Entity A manages its investment in Entity B on a fair value basis and should account for that investment at fair value.

Example 2 – private equity organization that controls another entity

Fact pattern

A4. Entity A is a private equity organization that holds equity instruments of entities in the mining sector, including 53% of the outstanding equity of Entity C. Entity A reports financial information to investors each quarter, which includes details about the fair values of its investments. Management of Entity A are compensated based on fixed amounts plus an incentive fee of 20% of its net assets, calculated monthly based on the fair values of its assets and liabilities, in excess of a target threshold.

Incentive fees represent approximately half of the total compensation to management on average. Entity A's investment strategy is to hold the shares of Entity C until they reach a target price, at which point Entity A intends to dispose of the investment. Entity A is not involved in the day-to-day operations of Entity C and has not imposed any changes to management, systems or processes at Entity C subsequent to the acquisition of control.

Analysis

A5. A major component of Entity A's compensation arrangement with its management (i.e. incentive fee), and its reporting to investors, is based on the fair value of the entity's investments, including its investment in Entity C. Entity A is not involved in the day-to-day operations of Entity C and has acquired the investment with an exit strategy in place. Therefore, we would conclude that Entity A is managing its investment in Entity C on a fair value basis and should account for the investment at fair value.

Example 3 – venture capital organization that controls another entity

Fact pattern

A6. Entity A is a venture capital organization that owns 75% of outstanding equity of Entity D, a pharmaceutical company that is in the start-up phase of operations. Entity A controls Entity D. Upon acquisition of control, Entity A replaced the CEO and CFO of Entity D with members from its own management team and implemented its own reporting and control procedures. Entity A monitors its investment in Entity D by gauging the cash flows it generates against predetermined thresholds.

Analysis

A7. Entity A is involved in the day-to-day operations of Entity D because its own management team is managing Entity D. Entity A imposed its own systems and processes on Entity D and focuses on the cash flows, rather than fair value, of Entity D. Therefore, we would conclude that Entity A is not managing its investment in Entity D on a fair value basis as its activities extend beyond holding the investment and, as such, Entity A should consolidate Entity D.

Example 4 – operating entity establishes new entity to acquire another operating entity

Fact pattern

A8. Entity A is a large financial institution with diverse operations, which include significant insurance operations. Entity F is a small insurance company that operates in rural areas not captured by Entity A's existing operations. Entity A establishes a new entity, Entity E, that exists only to hold its investment in Entity F. Management of Entity A and Entity F are compensated based on fixed amounts and bonuses that are based on the net income and cash flows of Entity A's operations, including those attributable to Entity E and Entity F.

Analysis

A9. Entity A is able to increase its insurance business by accessing additional areas, as a result of its acquisition of Entity F through Entity E. Entity A does not have an exit strategy and is not otherwise required to be prepared to dispose of its investment. Entity A does not compensate its management based on changes in the fair value of Entity F or Entity E. Therefore, we would conclude that Entity A is not managing its

investment in Entity E on a fair value basis and should consolidate Entity E and Entity F.

Example 5 – Entity with established investment division that controls an operating entity

Fact pattern

A10. Entity A is a large financial institution with diverse operations, which include a private equity division. Entity G's only operations are to conduct private equity activities on behalf of Entity A. Entity G is 100% owned by Entity A. Entity H is a computer manufacturer that is controlled by Entity G. Entity G manages and evaluates the performance of its investments on a fair value basis and reports all investments, including its subsidiary Entity H, at fair value in its stand-alone financial statements. Entity A acquires computers for its offices from Entity H without consideration. Entity A does not have any formal policies that restrict the investing activities of any of its subsidiaries or affiliates and does not manage any of its own controlled investments on a fair value basis.

Analysis

A11. Entity A is the parent company of Entity G, which controls Entity H. Entity A obtains benefits from Entity H and Entity A does not have any policies that distinguish the investments of Entity G from those of other entities within the group. Therefore, we would conclude that Entity A should not retain fair value accounting for the investment and should consolidate Entity H.

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