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IFRS

# First Impressions: Consolidation relief for investment funds

November 2012

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## Green light for fair value accounting

This consolidation exception for investment funds is a big step by the IASB in aligning external financial reporting with the way in which investment funds operate. Investment funds have long sought relief from consolidation, and the IASB has responded with an industry-specific solution. It requires qualifying investment entities to recognise their investments in controlled entities in a single line item in the statement of financial position, measured at fair value through profit or loss. This is a significant, positive change compared with the previous position in IFRS.

Many in the funds industry will welcome these amendments. However, the decision that a parent that is not an investment entity will still be required to consolidate all subsidiaries may be less welcome. Parent entities of an investment entity that are less likely to qualify as investment entities under the definition include many banks, insurers and some investment managers.

Although this change could encourage qualifying investment funds to switch to IFRS, we watch with interest to see how the IASB tackles a key remaining question: the basis on which to measure the fair value of investments held by an investment fund. In particular, can the fair value of a controlling stake in a company include a control premium? If not, then enthusiasm for fair value accounting is likely to diminish. As we go to print, it is expected that the question will be debated by the IFRS Interpretations Committee early in 2013.

We hope that this publication helps you to better understand the amendments, and whether your organisation qualifies as an investment entity.

Tom Brown  
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# 1. Highlights

- On 31 October 2012, the IASB published *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)*. The IASB has acknowledged that this industry-specific amendment deviates from its usual policy of focusing on the substance of transactions and avoiding industry-specific requirements; however, it believes that in this instance the sector approach could bring multiple benefits, and might see more investment funds adopting IFRS, given the choice.
- A qualifying investment entity is *required* to account for investments in controlled entities – as well as investments in associates and joint ventures – at fair value through profit or loss (FVTPL); the only exception would be subsidiaries that are considered an extension of the investment entity’s investing activities. The consolidation exception is mandatory – not optional.
- To qualify, an entity is required to meet the following tests:
  - the entity obtains funds from one or more investors to provide those investors with **investment management services**;
  - the entity commits to its investors that its business purpose is to invest for returns solely from **capital appreciation and/or investment income**. Investment-related services provided to investors are not prohibited, but some services to investees are restricted and some relationships and transactions with investees are prohibited; and
  - the entity measures and evaluates the performance of substantially all investments on a **fair value basis**.
- In addition, an investment entity ‘typically’ has:
  - more than one investment;
  - more than one investor;
  - investors that are not related parties; and
  - ownership interests in the form of equity or similar interests.
- To the extent that an investment entity does not have these four characteristics, it is required to disclose the significant judgements and assumptions made in concluding that it is an investment entity.
- The parent of an investment entity (that is not itself an investment entity) is still required to consolidate all subsidiaries.
- New disclosures include quantitative data about the investment entity’s exposure to risks arising from its unconsolidated subsidiaries – i.e. the disclosures now apply to the investee as a single investment rather than to the consolidated investee’s underlying financial assets and financial liabilities.
- The amendments apply to annual periods beginning on or after 1 January 2014. However, early adoption is permitted, which means that a qualifying investment entity might be able to adopt the amendments as early as 31 December 2012.

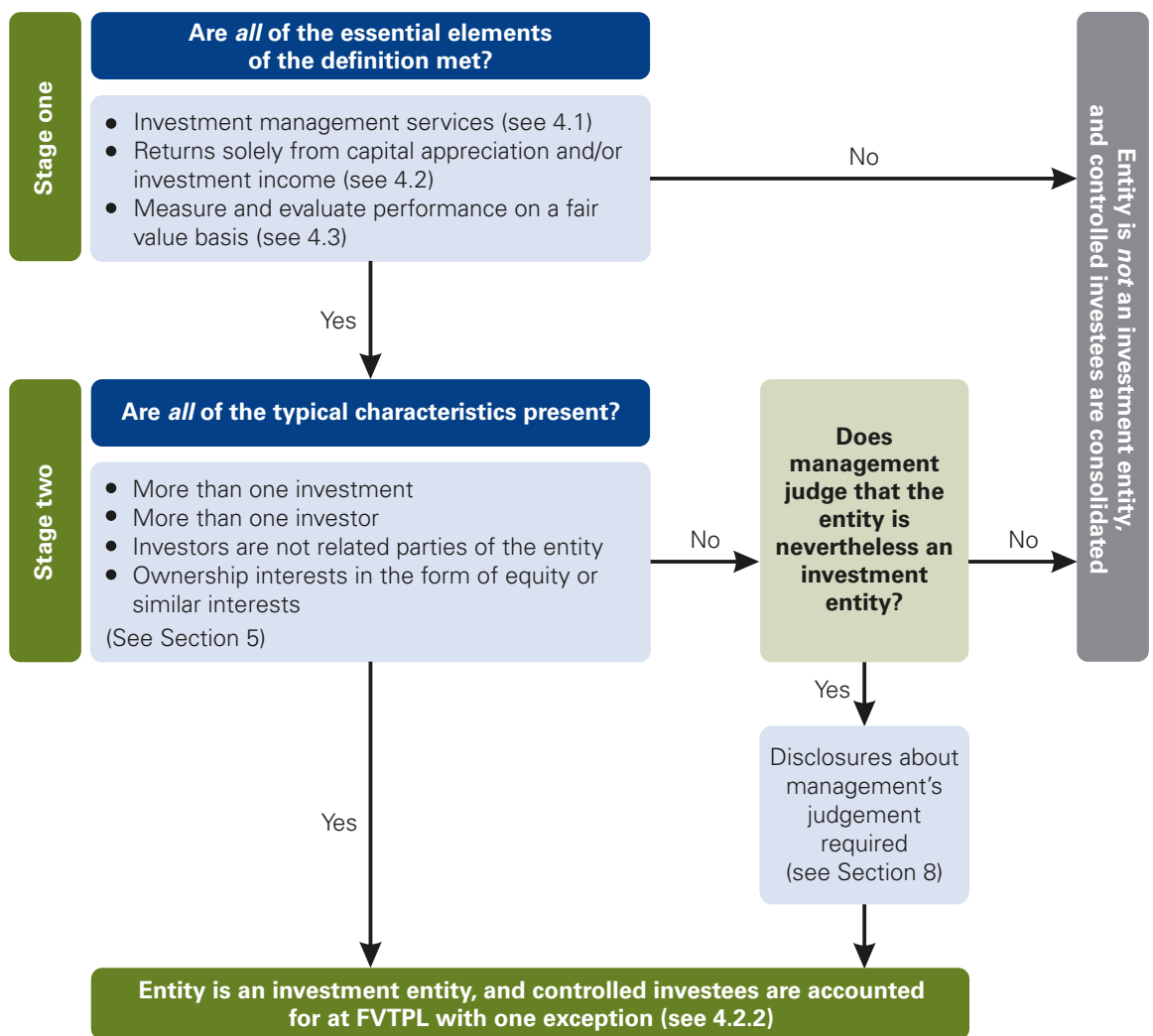
## 2. How this could affect you

- **Judgement required in assessing qualifying criteria.** Most conventional fund structures are expected to meet the investment entity definition and have the typical characteristics. However, a minority of structures – e.g. some private equity funds – will need to apply significant judgement during the assessment process.
- **Fair value accounting for associates and joint ventures also required.** To qualify as an investment entity, an entity is required to account for investments in associates and joint ventures at FVTPL. For venture capital and similar organisations that in any event do not qualify as investment entities, the exemption from equity accounting remains optional.
- **Investment entity exception for a qualifying parent is mandatory – not optional.** Some entities might qualify as investment entities but would rather consolidate controlled investees – e.g. some feeder funds in a master-feeder structure. However, because the consolidation exception is mandatory, such entities cannot consolidate in their financial statements. Instead, the removal of the requirement to consolidate presents an opportunity to rethink the reporting of financial information to investors – e.g. an investment entity may wish to adopt a more integrated reporting approach, or to present additional supplementary information.
- **Consolidation exception is not extended to a parent entity that does not qualify.** The consolidation exception is not carried through to the consolidated financial statements of a parent that is not itself an investment entity. Therefore, in many cases the cost saving will be lost because consolidation will still be required, just at a higher level.
- **Fair value measurement question remains.** There is no guidance on the basis on which to measure fair value – e.g. whether an investment entity should measure its investment in a controlled investee on the basis of the value of an individual share (unit), or whether a control premium should be included in the valuation. The IFRS Interpretations Committee is expected to consider the issue in the near future and investment funds should monitor the discussions closely.
- **Additional disclosures required.** The most important disclosure implications are likely to be the application of IFRS 7 *Financial Instruments: Disclosures* at the investee level. Previously the disclosures applied to the consolidated investee's underlying financial assets and financial liabilities.
- **Adoption is imminent.** If an investment entity wants to take advantage of the amendments at the end of its current reporting period (perhaps as early as 31 December 2012), then it has only a short period in which to analyse the amendments and determine the changes in its reporting to investors and other stakeholders.
- **A broad impact is expected across the financial services sector.** *Mutual and hedge funds* are generally expected to be able to take advantage of the consolidation exception. *Private equity funds* are also likely to qualify, and were a key focus of the IASB in approving the consolidation exception. The more passive *real estate funds* might qualify – the focus is likely to be on the business purpose and fair value measurement and performance evaluation tests.



### 3. A two-stage approach

To qualify as an investment entity, an entity needs to consider all facts and circumstances, including its purpose and design. The amendments include a definition of an investment entity and provide typical characteristics that an investment entity is expected to display; we refer to this as the ‘two-stage approach’ in this publication. The diagram below is a general presentation of the model used to determine whether an entity qualifies as an investment entity.

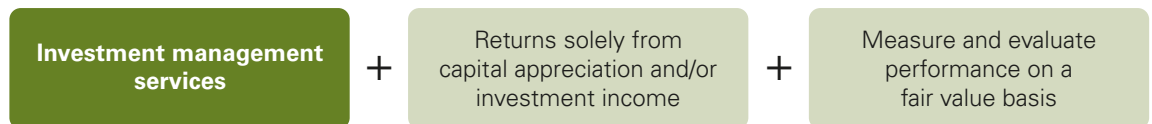


## 4. Essential elements of the definition – Always to be met

*IFRS 10.27, B85A*

An entity needs to meet all of the essential elements of the definition of an investment entity to qualify for the consolidation exception. In making this determination, management is required to consider all facts and circumstances, including the purpose and design of the entity.

### 4.1 Investment management services



*IFRS 10.27(a), BC237*

An investment entity obtains funds from investors to provide those investors with investment management services. The IASB believes that providing these services is necessary, though not on its own sufficient, to distinguish an investment entity from other types of entities. There is no further application guidance in the amendments regarding this particular requirement, but the second element of the definition includes guidance that permits certain investment-related services (see 4.2.2).

### 4.2 Returns solely from capital appreciation and/or investment income



*IFRS 10.27(b), B85B*

An investment entity commits to its investors that its business purpose is to invest for returns solely from capital appreciation and/or investment income. This commitment could, for example, be included in the offering memorandum, investor communications and/or other corporate or partnership documents. The investment plans of the entity provide evidence of its business purpose – i.e. an investment entity does not plan to hold its investments indefinitely (see 4.2.1).

*IFRS 10.B85C–B85D, B85I–B85J*

In addition, the amendments provide guidance on the types of relationships, transactions and services that are prohibited or permitted (see 4.2.2).

## 4.2.1 Potential exit strategies to be documented

IFRS 10.B85F, BC245

A documented potential exit strategy is required for substantially all investments that could be held indefinitely. The table below provides examples of instruments for which an exit strategy is required ✓ / not required ✗.

| Investment                           | Exit strategy required? |
|--------------------------------------|-------------------------|
| Equity investments                   | ✓                       |
| Investment property                  | ✓                       |
| Debt instruments with a set maturity | ✗                       |
| Perpetual debt instruments           | ✓                       |

### Insight – Indefinite-lived instruments

IFRS 10.B85F, BC247

The test of whether an investment could be held indefinitely is a question of fact. For example, an instrument that has an equity conversion feature, exercisable at the option of either the issuer or the holder, could be held indefinitely. This is because the conversion option means that the instrument could have an indefinite life (if it is converted).

IFRS 10.B85F–B85G

A potential exit strategy is not required for each investment, but rather for each type or portfolio of investments. The following are examples of exit strategies for financial and non-financial investments.

| Debt securities   | Equity investments   | Investment property   |
|---|--|---|
| <ul style="list-style-type: none"> <li>Private placement</li> <li>Converting debt to equity with subsequent sale</li> </ul> | <ul style="list-style-type: none"> <li>Initial public offering</li> <li>Private placement</li> <li>Distributions of ownership interests</li> </ul> | <ul style="list-style-type: none"> <li>Sale on the open market</li> <li>Private placement through an agent</li> </ul> |

IFRS 10.B85F

Exit strategies that are put in place only for default events – such as breach of contract or non-performance – are not considered exit strategies for the purposes of this assessment.

IFRS 10.B85H, BC248

The feeder fund in a master-feeder structure does not itself require a potential exit strategy for its investment in the master fund. However, the master fund does require a potential exit strategy for all of its investments that could be held indefinitely.

### Insight – Change in investment strategy

IFRS 10.29

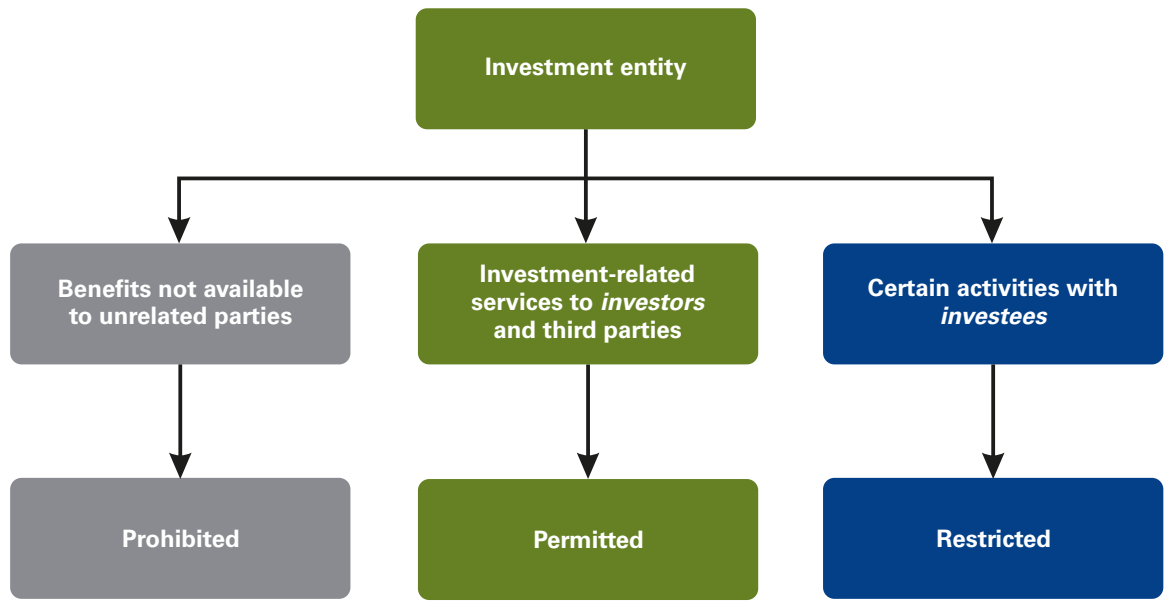
In continuing to qualify as an investment entity, the amendments do not rule out a change in the detail of a fund's investment strategy, as long as the entity's business purpose is still to obtain returns solely from capital appreciation and/or investment income and it continues to have potential exit strategies.



## 4.2.2

### Relationships, transactions and services

The amendments include specific guidance on certain relationships, transactions and services.



#### Prohibited benefits

IFRS 10.B85I

The standard includes the following examples of relationships and transactions that preclude an entity from qualifying as an investment entity; this is because they indicate that the entity is investing to earn benefits other than capital appreciation and/or investment income.

- Acquiring, using, exchanging or exploiting intangible assets, technology or processes of an investee; this includes exclusive or disproportionate rights to acquire assets, technology, products or services – e.g. an option to buy an asset if its development is successful.
- Participation as a joint controller in a joint arrangement, the purpose of which is to develop, produce, market or provide products or services; see Chapter 3.6A of the 9<sup>th</sup> Edition 2012/13 of our publication [Insights into IFRS](#) for further guidance on the concept of a joint arrangement.
- Obtaining a guarantee or collateral from an investee over the entity's borrowings; however, this does not preclude an investment entity from using its investment in an investee as collateral for borrowings.
- A related party of the investment entity holding an option to acquire ownership interests in the investee from the entity.
- Other transactions:
  - with terms that are not available to investors that are not related parties;
  - that are not at fair value; or
  - that represent a significant portion of the business activities of the investee.

*IFRS 10.B85I, B85J, BC242*

The above restrictions cover not only the entity itself, but also any member of the larger group of which it is a part – i.e. any subsidiary of the entity's ultimate parent. However, merely because investees trade with each other does not preclude an entity from qualifying as an investment entity. The IASB incorporated these restrictions into the amendments to avoid abuse – e.g. to ensure that an entity did not seek to establish an investment entity subsidiary within a corporate structure that would be used to hold loss-making subsidiaries.

The following example is derived from the illustrative examples published with, but not forming an integral part of, the amendments.

#### Example – Option held by related party

*IFRS 10.IE7–IE8*

|                 |  |
|-----------------|--|
| <b>Scenario</b> | <ul style="list-style-type: none"> <li>• High-technology Fund (HT) was formed by Technology Corporation (TC) to invest in technology start-up companies for capital appreciation.</li> <li>• TC has a 70% ownership interest in HT. The remaining 30% is owned by 10 unrelated investors.</li> <li>• TC holds an option to acquire the investments held by HT at their fair value, if the underlying technology would benefit the operations of TC.</li> </ul> |
| <b>Analysis</b> | HT does not qualify as an investment entity, because the option held by TC provides a benefit in addition to capital appreciation and/or investment income.  |

#### Permitted services to investors

*IFRS 10.B85C, BC239*

As part of its activities, an investment entity is permitted to provide investment-related services to investors. Such services could include, for example, investment advisory services, investment management, investment support and administrative services. Even if the investment-related services are substantial and are also provided to third parties, this does not preclude an entity from qualifying as an investment entity. The IASB agreed with arguments that such services are simply an extension of an investment entity's investing activities.

#### Restricted activities with investees

*IFRS 10.B85D, BC241*

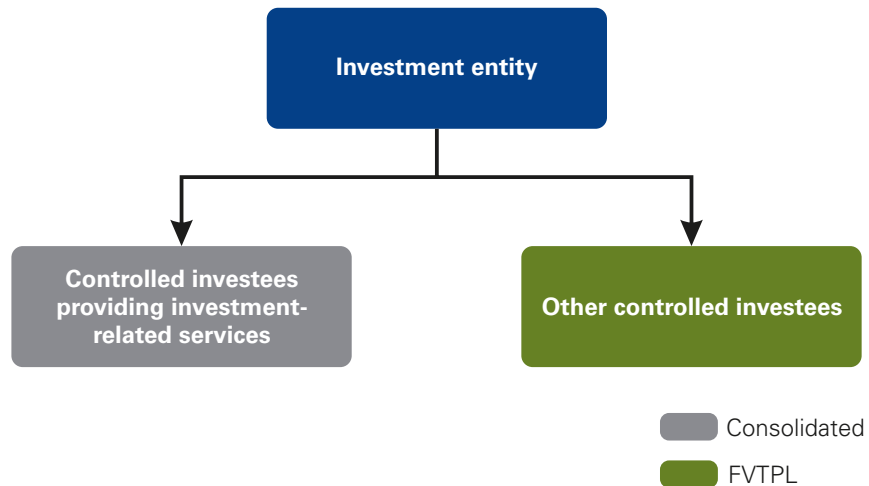
However, providing management services or strategic advice to the investee, or providing financial support to the investee – e.g. through a loan, capital commitment or guarantee – is prohibited, unless these activities:

- do not represent a substantial business activity or a separate substantial source of income of the entity; and
- are undertaken to maximise the investment return from the investee.

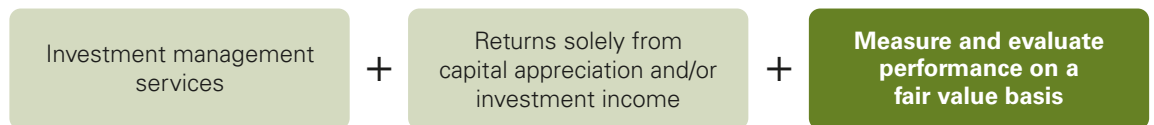
#### Insight – Private equity funds set to be the major beneficiaries

The decision to allow investment-related services was a result of late redeliberations by the IASB, and was intended to benefit private equity funds. Although management will need to exercise judgement, specifically when restricted activities are performed, there is an expectation that such funds will often qualify as investment entities.

*IFRS 10.32, B85C, B85E* Permitted investment-related services may be provided directly or through a subsidiary. As shown in the diagram below, subsidiaries providing such services will be consolidated.



### 4.3 Measure and evaluate performance on a fair value basis



*IFRS 10.27(c), B85K*

The final element of the definition of an investment entity is the measurement and performance evaluation of ‘substantially all’ investments on a fair value basis. Meeting this requirement indicates that fair value is the primary driver of the decision-making process for both management and investors.

*IFRS 10.B85K–B85L*

To meet these requirements:

- in all instances permitted by IFRS, investments should be accounted for under the fair value model, including the following requirements:
  - investment property should be measured at fair value under IAS 40 *Investment Property*;
  - financial assets should be measured at fair value under IFRS 9 *Financial Instruments*, or to the extent possible under IAS 39 *Financial Instruments: Recognition and Measurement*; and
  - investments in associates and joint ventures should be measured at fair value under IAS 28 (2011) *Investments in Associates and Joint Ventures* (see also Section 6); and
- fair value information should be used by key management personnel as the primary attribute in evaluating the performance of investees and in making investment decisions.

*IFRS 10.BC251*

The recognition of changes in fair value in other comprehensive income (OCI) does not preclude an entity from qualifying as an investment entity – e.g. available-for-sale financial assets under IAS 39.

*IFRS 10.B85M*

An entity that accounts for a more than insignificant portion of its investment under a cost model will not qualify as an investment entity. However, non-investment assets – e.g. own-use property and equipment under IAS 16 *Property, Plant and Equipment* – and financial liabilities need not be measured at fair value.

### Insight – Judgement required in assessing ‘substantially all’

*IAS 40.53*

There is no specific guidance on the threshold required for an entity to conclude that it measures and evaluates the performance of ‘substantially all’ investments on a fair value basis, and management will need to use its judgement. For example, an entity may account for investment property under the fair value model, but within that model some properties might be accounted for under the cost model because fair value cannot be determined reliably. In that case, the entity will assess the extent of its investment property accounted for under the cost model to determine if the ‘substantially all’ test is met.

### Insight – Fair value accounting for venture capitalists maintained

The August 2011 exposure draft that preceded the amendments proposed that only investment entities should account for investments in associates and joint ventures at FVTPL. This would have meant that the exemption from equity accounting would have been lost for venture capital and similar organisations that do not qualify as investment entities. However, in response to comments from constituents, the IASB decided to retain the exemption.

As a result, the measurement exemption in IAS 28 (2011) applies as follows.

*IFRS 10.B85L(b)*

- As noted above, an investment entity is required to elect to measure investments in associates and joint ventures at FVTPL.

*IAS 28 (2011). 18–19*

- A venture capital or similar organisation that does not qualify as an investment entity may choose to measure all of its investments in associates and joint ventures at FVTPL.

### Insight – Debt funds may seek investment entity status

In our experience, debt funds do not typically measure investments on a fair value basis and therefore would not qualify as investment entities. In many cases, this would not be relevant because the fund would not take a controlling stake in an investee.

However, in certain situations following a financial restructuring, a debt fund may take a controlling equity stake, which may result in the requirement to consolidate the underlying investee; this is because the fund may still have debt investments that are measured on an amortised cost basis. For this reason, following the amendments, qualification as an investment entity may form part of the impact analysis on the restructuring of a debt fund.

## 4.4 Applying the definition – Example

The following example is derived from the illustrative examples published with, but not forming an integral part of, the amendments.

IFRS 10.IE9–IE11

|                        |  |
|------------------------|--|
| <p><b>Scenario</b></p> | <ul style="list-style-type: none"> <li>• A Real Estate Fund (REF) develops, owns and operates retail, office and other commercial property through its wholly owned subsidiaries, each holding a separate property.</li> <li>• Property investments held within the subsidiaries are accounted for by REF and each of its subsidiaries at fair value under IAS 40.</li> <li>• REF does not have a set timeframe for disposing of its property investments, but uses fair value to identify the optimal time for disposal. REF and its investors also consider other factors (e.g. expected cash flows) in making their decisions.</li> <li>• Although fair value is a key performance indicator, key management personnel do not consider it a key attribute in assessing performance.</li> <li>• REF undertakes property and asset management activities, including property management, capital expenditure and tenant selection, which it outsources to third parties. These are a substantial part of REF's business.</li> </ul> |
| <p><b>Analysis</b></p> | <p>REF does not qualify as an investment entity for any of the following reasons – i.e. any one of the following precludes REF from qualifying as an investment entity.</p> <ul style="list-style-type: none"> <li>• REF has a separate substantial business activity (property and asset management) – i.e. its activities go too far beyond earning returns from capital appreciation and/or investment income (see 4.2.2).</li> <li>• REF does not have exit strategies for its investments in real estate (see 4.2.1).</li> <li>• Fair value is one of the performance indicators used by REF. However, it is not the primary attribute used by key management personnel in evaluating performance and making investment decisions (see 4.3).</li> </ul>   |
| <p><b>Insight</b></p>  | <p>The wording of the illustrative example on real estate funds suggests that the IASB intends very few real estate funds to qualify as investment entities. In our experience, real estate funds may be involved in construction or redevelopment, and it is common for them to be involved in operations. Judgement is required to evaluate, using the facts and circumstances for each case, whether these activities are substantial business activities.</p>  |



## 5. Typical characteristics may trigger disclosure

*IFRS 10.28, BC255*

The IASB expects an entity that meets the definition of an investment entity to typically have the characteristics summarised in the table below.

*IFRS 10.B85N*

The absence of one or more of these typical characteristics does not immediately disqualify an entity from being classified as an investment entity – i.e. it is possible for an entity to have none of these characteristics and still qualify as an investment entity. However, in such cases additional judgement is required by management in determining whether the entity qualifies.

| The investment entity:   | Comments  |
|--------------------------|---|
| <i>IFRS 10.B85O–B85P</i> | <p><b>Holds more than one investment</b></p> <ul style="list-style-type: none"> <li>• Generally, an investment entity is expected to hold multiple investments in order to diversify its risks and maximise returns. However, the amendments acknowledge that this may not always be the case.</li> <li>• An investment entity might hold a single investment in the following situations, for example:               <ul style="list-style-type: none"> <li>– a start-up or wind-up period; or</li> <li>– when its purpose and design is to provide investors with access to an investment that they wouldn't otherwise have access to – e.g. a feeder fund or because the entry price is too high.</li> </ul> </li> </ul>   |
| <i>IFRS 10.B85Q–B85S</i> | <p><b>Has more than one investor</b></p> <ul style="list-style-type: none"> <li>• An investment entity is generally expected to have multiple investors. The IASB believes that this means that the entity (or entities in the same group) is less likely to earn returns other than capital appreciation and/or investment income (see 4.2).</li> <li>• However, the amendments acknowledge that in some cases a single investor is entirely credible. For example, a pension fund, government investment fund or family trust might be a single investor, representing a wider group of investors. Alternatively, there might be a single feeder fund in a master-feeder structure.</li> <li>• Sometimes a single investor will be temporary – e.g. in the investment entity's start-up or wind-up period.</li> </ul> |
| <i>IFRS 10.B85T–B85U</i> | <p><b>Has investors that are not related parties</b></p> <ul style="list-style-type: none"> <li>• Another typical characteristic of an investment entity is having investors that are not related parties (as defined in IAS 24 <i>Related Party Disclosures</i>). Again, the IASB believes that this makes it less likely that the entity (or entities in the same group) is earning returns other than capital appreciation and/or investment income (see 4.2).</li> <li>• However, the amendments provide the example of a fund set up for members of key management personnel that mirrors the investments of the entity's main investment fund. Such an arrangement does not preclude investment entity status.</li> </ul>   |

IFRS 10.B85V–B85W

| The investment entity:  | Comments   |
|---|--|
| <b>Has ownership interests in the form of equity or similar interests</b> | <ul style="list-style-type: none"> <li>• An investment entity is not required to be a legal entity, which means that the beneficial interests in the entity will not necessarily be in the form of equity or similar interests.</li> <li>• Each unit of ownership in an investment entity typically represents a specifically identifiable proportionate share in its net assets. However, it is also acceptable for an investment entity to have multiple classes of investors with separate investment pools per class or different proportionate shares of net assets or differential rights in the proportionate share of net assets – e.g. in a waterfall structure.</li> <li>• An investment entity may have significant ownership interests that are classified as liabilities under IAS 32 <i>Financial Instruments: Presentation</i>, as long as debt holders are exposed to variable returns from changes in the fair value of the entity's net assets.</li> </ul> |

#### Insight – No specific criteria in assessing characteristics

The IASB adopted the two-stage approach in response to criticism of the more bright-line approach that was included in the August 2011 exposure draft that preceded the amendments. For this reason, the amendments do not provide specific criteria that management should consider in assessing whether an entity qualifies as an investment entity despite failing one or more of the typical characteristics. However, the basis for conclusions notes that the IASB believes that only in rare circumstances would an investment entity have none of the typical characteristics.

IFRS 12.9A

An investment entity is required to disclose its reasons for concluding that it is nevertheless an investment entity when one or more of these characteristics is not met.

## 6. Parents of investment entities

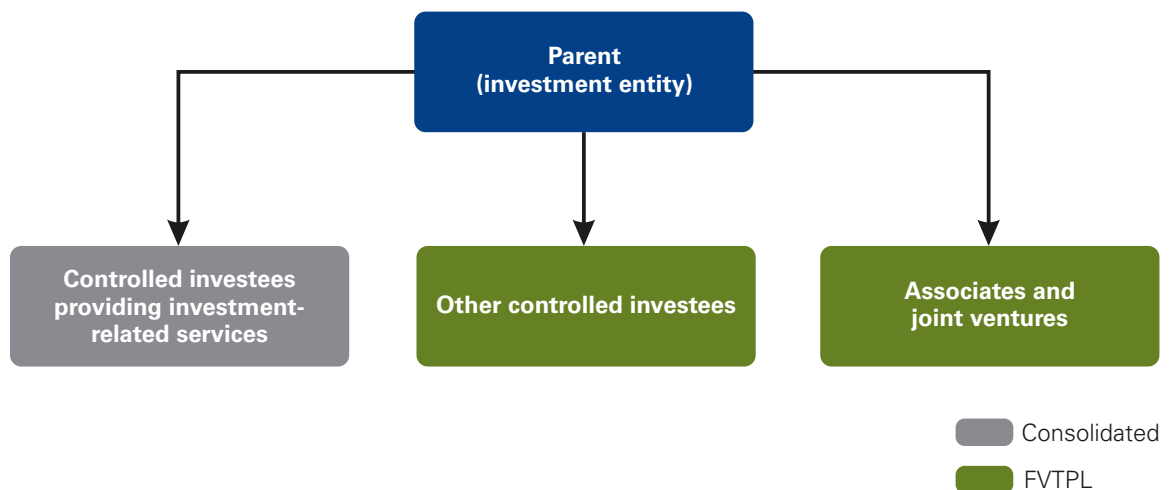
### 6.1 Parent is an investment entity – Fair value accounting mandatory

IFRS 10.33

The investment entity consolidation exception is mandatory for the parent of an investment entity that itself meets the definition of an investment entity. This means that the parent of an investment entity is *required* to account for its investments in controlled investees at FVTPL, even if the investment entity subsidiary was formed for specific regulatory, legal or tax purposes – e.g. in a master-feeder structure.

IFRS 10.B85L(b)

In addition, because the parent is an investment entity, any investments in associates and joint ventures are required to be accounted for at FVTPL (see 4.3).



IFRS 10.BC272–  
BC273

Despite feedback on the August 2011 exposure draft that certain respondents saw more benefits from reporting on a consolidated basis, the IASB decided against such an approach. Its reasoning was that no conceptual basis exists for distinguishing between different investment entity subsidiaries. An additional complication would arise from trying to distinguish investment entity subsidiaries formed for regulatory, legal or tax purposes from those that were not.

#### Insight – Financial reporting of master-feeder structures

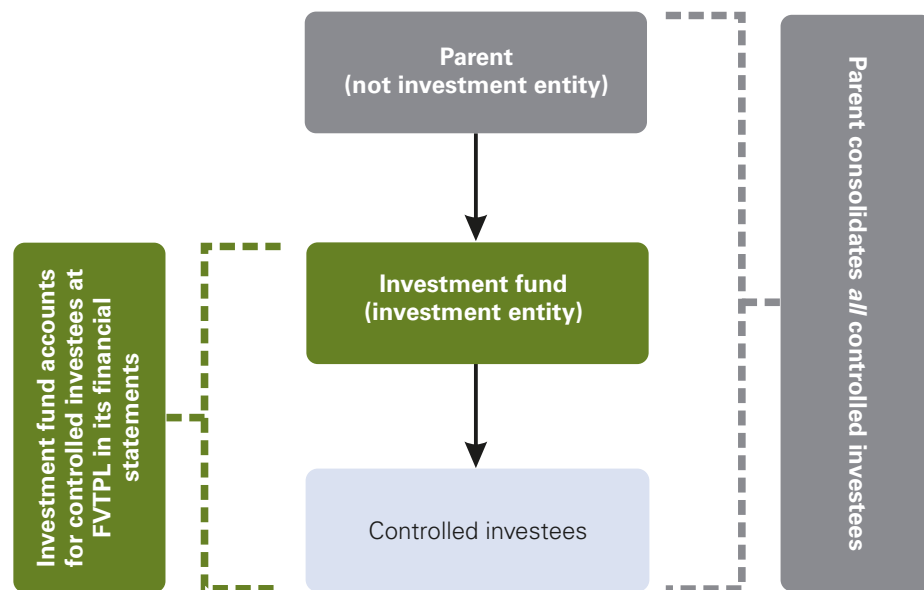
Master-feeder structures, which are generally expected to fall within the definition of an investment entity, often seek to present to investors information about the underlying investments of the master fund – therefore, they may prefer to consolidate. Understandably, it is essential for users of the feeder fund's financial statements to have information about the underlying investments of the master fund.

As one possible solution, some constituents suggested introducing a requirement to append subsidiaries' financial statements to the parent's financial statements. The IASB rejected this solution as a requirement, but IFRS 12 *Disclosure of Interests in Other Entities* explicitly acknowledges that the financial statements could be attached (see Section 8). Alternatively, feeder funds can consider whether to present consolidated financial statements, or information on a proportionate consolidation basis, as supplementary information.

## 6.2 Parent is not an investment entity – Exception not carried through

IFRS 10.33, BC275

The consolidation exception is not carried through to the consolidated financial statements of a parent that is not itself an investment entity – i.e. the parent is nevertheless required to consolidate all subsidiaries.



IFRS 10.BC277–  
BC278

The majority of respondents to the August 2011 exposure draft disagreed with this proposal. However, the IASB decided to retain the proposal, because a key factor in granting the consolidation exception in the first place was the unique business model of investment entities, which the higher-level parent may or may not have.

IFRS 10.BC242

The IASB is also concerned that an ‘internal’ investment entity could be misused in a larger corporate structure – e.g. a manufacturing group – to achieve a particular accounting outcome. The basis for conclusions gives the example of a group that uses an internal investment entity to record investments in loss-making activities within the group – e.g. the group’s research and development activities – to avoid consolidating those activities. Such an internal investment entity would not qualify for the exception, because benefits are obtained from investees that are unavailable to other investors (see 4.2.2).

### Insight – Potentially broad consequences

Although many investment entities will have a parent that is an investment entity – which means that the exception will be carried through – in our experience, some will have a parent that is a non-qualifying bank or an insurance company or another non-investment entity. Also, situations may arise in which the investment manager will control the investment fund under IFRS 10 *Consolidated Financial Statements* – see our publication [IFRS Practice Issues: Applying the consolidation model to fund managers](#) – and will therefore be required to consolidate all of the subsidiaries of the investment fund accounted for by the fund at fair value. In such situations, any cost saving will be lost because consolidation will still be required, but at a higher level.

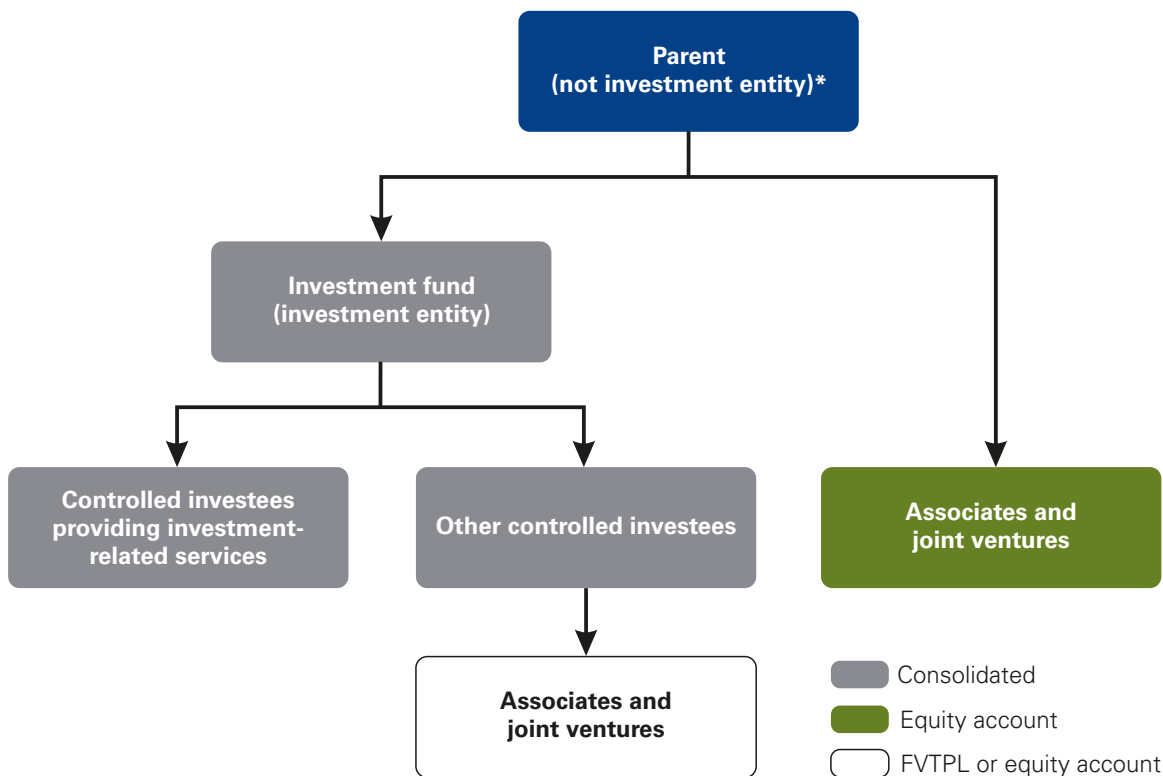
IAS 28 (2011).18–19

Even if the parent is not an investment entity, any investments in associates and joint ventures held through the investment-entity subsidiary may be accounted for at FVTPL – i.e. the parent (investor) has an accounting policy choice.

**Insight – Associates and joint ventures treated differently from subsidiaries**

IFRS 10.BC283

The IASB has acknowledged the inconsistency between the treatment of associates and joint ventures (fair value accounting may be carried through) and the treatment of controlled investees (fair value accounting cannot be carried through). However, the IASB thought that it was important to keep the carry-through of the existing fair value measurement exemption for parents of venture capital and similar organisations, which would otherwise be required to commence equity accounting.



\* In this example, the parent itself does not qualify as a venture capitalist or similar organisation, and therefore direct holdings in associates and joint ventures are equity accounted.

**Insight – Potential differences with US GAAP**

The FASB is currently finalising its deliberations on amended accounting requirements for entities that qualify as investment companies. The FASB’s *Accounting Standards Update*, which is expected to be issued in the first half of 2013, is expected to differ from the IFRS proposals in two key respects.

- Unlike IFRS, the FASB is expected to permit certain investment company parents to consolidate their investment company subsidiaries.
- Unlike IFRS, the FASB is expected to require a non-investment company parent to retain the investment company’s accounting at the group level.

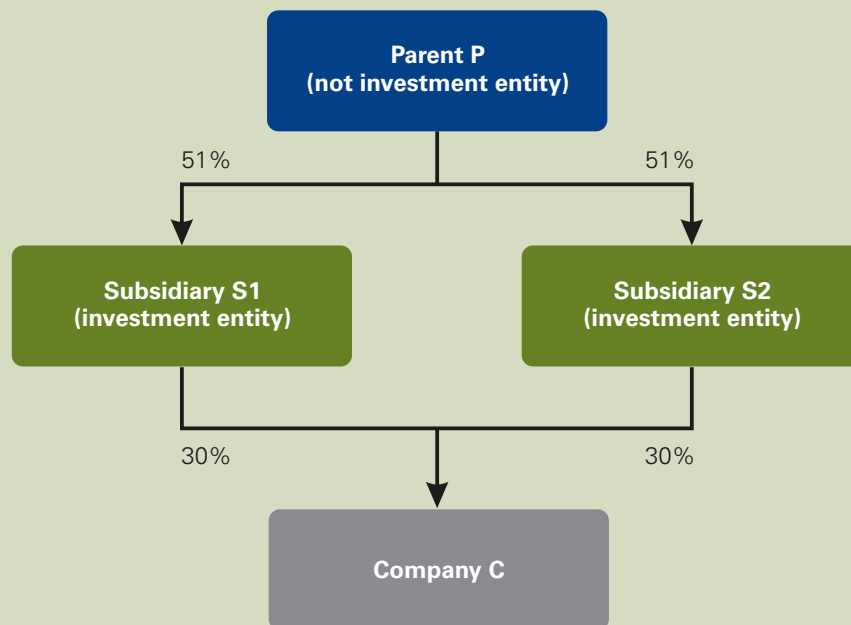
See Section 11 for further differences expected.



### Example – Split holding

A parent of an investment entity that is not an investment entity has an indirect interest in an investee.

- Parent P (which is not an investment entity) has two investment entity subsidiaries, S1 and S2.
- S1 and S2 each have significant influence in Company C, and account for their respective investments at FVTPL (see 4.3).
- At the consolidated level, P controls C through its 51% holdings in S1 and S2.



IFRS 10.33

In this example, P would consolidate C. This is on the basis that IFRS 10 requires a non-investment entity parent to consolidate *all* subsidiaries – i.e. both direct and indirect.

## 7. Fair value measurement question remains

IFRS 13.A

In measuring fair value, investment entities will follow the guidance in IFRS 13 *Fair Value Measurement*, which defines fair value as: “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”.

IFRS 13.A

Market participants are independent – i.e. not related parties under IAS 24 – knowledgeable, able and willing to enter into a transaction; however, the price in a related party transaction may be used as an input to a fair value measurement if the fund has evidence that the transaction was entered into on market terms.

IFRS 13.62, B5–B6, B8, B11

Valuation techniques used to measure fair value fall into three approaches.

| Approach               | Comments   |
|------------------------|--|
| <b>Market approach</b> | <i>The market approach</i> comprises valuation techniques that often derive market multiples from a set of comparable assets. A market multiple expresses the value of a business in terms of its ratio to a financial, operating or physical metric. For example, a price-to-earnings ratio expresses an entity’s per-share value in terms of its earnings per share. The multiple can then be applied to the metric of an entity with similar characteristics but different scale, subject to adjustment for differences between the entity and the selected comparable. When multiples are derived from a number of comparable entities, there will typically be a range of multiples calculated. |
| <b>Income approach</b> | <i>The income approach</i> comprises valuation techniques that convert future amounts, such as cash flows or income streams, to a current amount on the measurement date. The fair value measurement reflects current market expectations about those future amounts, discounted to their present value.   |
| <b>Cost approach</b>   | <i>The cost approach</i> comprises valuation techniques that reflect the amount that would be required to replace the service capacity of an asset. This approach is not used for the valuation of financial assets.   |

IFRS 13.72

To improve consistency and comparability, IFRS 13 establishes a *fair value hierarchy* based on the inputs to the valuation techniques. The inputs are *categorised into three levels* – the highest priority is given to unadjusted quoted prices in active markets for identical assets or liabilities, and the lowest priority is given to unobservable inputs.

IFRS 13.76, 81, 86, A

The fair value hierarchy is made up of three levels.

- *Level 1 inputs* are unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.
- *Level 2 inputs* are inputs, other than quoted prices included within Level 1, that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- *Level 3 inputs* are unobservable inputs for the asset or liability.

See Chapter 2.4A of the 9<sup>th</sup> Edition 2012/13 of our publication [Insights into IFRS](#) for further guidance on fair value measurement.

### Insight – Unit of account

The 'unit of account' is a concept introduced by IFRS 13 to define the level at which fair value is measured. However, although IFRS 13 explicitly introduces the concept of the 'unit of account', it is determined in accordance with the relevant IFRS that requires or permits the fair value measurement. In many cases, the unit of account can be inferred. However, for a financial asset that is an investment in a subsidiary, joint venture or associate it is not clear; this is because the investment held by the entity comprises a number of individual shares (units).

A number of views might be possible under IFRS 13, and it is not clear what the IASB intended when the standard was issued. Two possible views are outlined below.

- *The unit of account is the entire investment.* This view is based on the fact that the accounting in the amendments is premised on the item as a whole, and not on it being a collection of smaller items. This means, for example, that the fair value of a controlled investee will include a control premium.
- *The unit of account is the individual share.* This view is based on the fact that, even if it is outside the scope of IAS 39 / IFRS 9, the unit of account for financial assets is the individual share. This means, for example, that the fair value of a controlled investee will be determined based on the quoted price of the individual share and will not include a control premium. This view is especially relevant for investment entities, because the amendments state that investments in controlled investees are accounted for 'in accordance with' IAS 39 / IFRS 9.

The IASB is aware of this question, and the IFRS Interpretations Committee is expected to consider this issue in the near future. Investment funds should monitor the discussions closely.

#### IFRS 10.BC225

During its deliberations, the IASB considered permitting the use of net asset value (NAV) as a practical expedient for fair value. However, the IASB decided against it due to the different calculation methods applied in different jurisdictions. Also, because it is a fair value measurement consideration, the area was deemed to be outside the scope of the investment entities project.

For further guidance on key considerations when assessing whether NAV is representative of fair value or can be used as an input into a valuation model, see our publication [IFRS for Investment Funds: Fair value measurement of financial assets and financial liabilities \(Issue 5\)](#).

## 8. New disclosures required

*IFRS 12.9A, 19A*

An entity discloses the significant judgements and assumptions that it has made in determining that it meets the definition of an investment entity. Furthermore, if an entity does not have one or more of the typical characteristics of an investment entity (see Section 5), then it discloses its reasons for concluding that it is nevertheless an investment entity.

IFRS 12 has been amended to incorporate disclosure requirements in respect of an investment entity's status and interests in unconsolidated subsidiaries. These disclosures include the following.

*IFRS 12.19D(b)–E*

### Unconsolidated subsidiaries that *are not* structured entities

- Any commitment or intention to provide financial or other support to controlled investees.
- Information about financial or other support provided, without a contractual obligation to do so, during the reporting period; this should include the reasons for providing support.

*IFRS 12.19F–G*

### Unconsolidated subsidiaries that *are* structured entities

- Contractual arrangements that could require the investment entity or its unconsolidated subsidiaries to provide financial support, including events or circumstances that could expose the investment entity to loss.
- Information about financial or other support provided, without a contractual obligation to do so, during the reporting period; this should include an explanation of the relevant factors in deciding to provide support.

*IFRS 7.40*

Before these amendments, the disclosure requirements of IFRS 7 applied to the underlying financial assets and financial liabilities of a controlled investee (on consolidation). IFRS 7 still applies, but now at the investee level. For example, the sensitivity analysis for each type of market risk to which the entity is exposed at the year end, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date, will apply at the investee level.

The fair value disclosures under IFRS 7 replace the previous disclosures required by IAS 28 (2011) for investments in associates and joint ventures. For example, there is no longer a requirement to provide summarised financial information about such investments.

*IFRS 24.4*

IAS 24 has been amended to clarify that related party transactions and balances between an investment entity and its unconsolidated subsidiaries should be disclosed in the investment entity's consolidated financial statements.

### Insight – Potential information overload

*IFRS 12.19B–C*

IFRS 12 requires the following basic disclosures about all unconsolidated subsidiaries (i.e. including indirect subsidiaries):

- the name of each subsidiary;
- its principal place of business; and
- the ownership interest/voting rights held.

When an investment entity has a subsidiary that is also an investment entity, the amendments to IFRS 12 allow, but do not require, an investment entity to disclose this information by incorporating the financial statements of controlled investees into its own consolidated financial statements.

Such an approach may be excessive in many cases, cluttering the financial statements so that key disclosures become less clear for readers of the financial statements. Instead, the amendments give management an opportunity to rethink the way in which they report to investors; this might better align internal and external reporting.



## 9. Changes in status accounted for prospectively

IFRS 10.29

An entity reassesses its status if facts and circumstances indicate that there has been a change in either one of:

- the factors in the essential elements of the definition of an investment entity (see Section 4); or
- the typical characteristics of an investment entity (see Section 5).

IFRS 10.30

Any change in status is accounted for prospectively.

Section 10 discusses changes in status as a result of adopting the amendments for the first time.

### 9.1 Qualifying for the first time

IFRS 10.25–26, B101

When an entity qualifies as an investment entity for the first time, it accounts for the change as a deemed loss of control of its subsidiaries. The difference between the previous carrying amount of the subsidiaries and their fair value at the date of the change in status is recognised as a gain or loss.

#### Example – Qualifying as an investment entity

IFRS 10.B98–B99

Investment Fund (IF) has consolidated Subsidiary S since its incorporation a number of years ago. IF has a 60% holding in S. On 1 June 2015, after the amendment to IFRS 10 came into effect, IF meets the criteria to qualify as an investment entity.

At 1 June 2015, the following information is relevant.

- The carrying amount of S's net assets in IF's consolidated financial statements is 1,000 (including any goodwill).
- The carrying amount of non-controlling interests (NCI) in equity is 400.
- The fair value of IF's 60% holding in S is 1,500.
- A credit of 150 (net of the amount attributed to NCI) is recorded in a revaluation reserve related to S's offices, which are measured on a fair value basis in accordance with IAS 16.

IF records the following entry at 1 June 2015.

|   | <i>Debit</i> | <i>Credit</i> |
|---|--------------|---------------|
| Investment in S   | 1,500        |               |
| NCI   | 400          |               |
| Revaluation reserve (Note)                                      | 150          |               |
| Retained earnings (Note)  |              | 150           |
| Gain on deemed loss of control                                  |              | 900           |
| Various assets and liabilities                                  |              | 1,000         |
| <i>To deconsolidate S on qualifying as an investment entity</i> |              |               |

IFRS 10.B99, B101,  
IAS 16.41

Note

The debit in the revaluation reserve is transferred directly to retained earnings, which is consistent with the treatment that would apply if the underlying property, plant and equipment had been disposed of directly. The transfer has no impact on the gain arising on the deemed loss of control.

IFRS 12.9B

An entity that qualifies as an investment entity discloses the effect of the change of status on the financial statements for the period presented, including:

- the total fair value of subsidiaries that ceased to be consolidated; and
- any gain or loss recognised as a result of the deemed loss of control, and the line item in which it is disclosed in profit or loss.

## 9.2 Ceasing to qualify

IFRS 10.30, B100

When an entity ceases to qualify as an investment entity, IFRS 3 *Business Combinations* is applied at that date in its consolidated financial statements (the deemed acquisition date). The fair value of controlled investees at the date of the change becomes the deemed consideration transferred to obtain control of the investee.

### Example – Ceasing to qualify as an investment entity

IFRS 10.B100

Investment Fund (IF) has been classified as an investment entity since it adopted the amendments to IFRS 10 on 1 January 2013 (early adoption); accordingly, its 60% holding in Subsidiary S has been accounted for at FVTPL.

On 1 June 2015, IF determines that it no longer meets the criteria to qualify as an investment entity. At that date, the following information is relevant.

- The carrying amount (fair value) of IF's investment in S is 1,500.
- The fair value of S's identifiable net assets is 1,000.
- IF elects to recognise NCI based on their interest in the net identifiable assets of S (rather than at the fair value of their shareholding). Therefore, their carrying amount at 1 June 2015 would be 400 (1,000 x 40%).

IF records the following entry at 1 June 2015.

|   | <i>Debit</i> | <i>Credit</i> |
|---|--------------|---------------|
| Identifiable net assets   | 1,000        |               |
| Goodwill (Note)   | 900          |               |
| NCI   |              | 400           |
| Investment in S   |              | 1,500         |
| <i>To consolidate S on ceasing to qualify as an investment entity</i> |              |               |
| Note  |              |               |
| Consideration transferred   | 1,500        |               |
| Plus NCI recognised   | 400          |               |
| Less identifiable net assets  | (1,000)      |               |
| Goodwill  | <u>900</u>   |               |

IFRS 3.32

### Insight – The subsidiary is not a business

*IFRS 10.B100, BC270*

The amendments require IFRS 3 to be applied to all *subsidiaries* when an entity ceases to be an investment entity – i.e. the requirements do not distinguish between a business and a group of assets that is not a business; for example, a single investment property in a corporate shell is often not a business.

*IFRS 3.2(b)*

However, IFRS 3 does provide specific guidance on the acquisition of an asset or group of assets that is not a business, which would apply when the subsidiary is not a business. In such cases, the consideration transferred (the fair value of the investee) would be allocated to the individual identifiable assets and liabilities based on their relative fair values.

## 10. Effective date and transition

- IFRS 10.C1B* The effective date of the amendments is annual periods beginning on or after 1 January 2014. However, early adoption is permitted, and therefore an entity is able to adopt the amendments at the same time as IFRS 10 – i.e. annual periods beginning on or after 1 January 2013 (although early adoption of IFRS 10 itself is also permitted).
- IFRS 10.C3A* An entity tests whether it is an investment entity at the ‘date of initial application’ of the amendments. If an entity with a calendar year end adopts the amendments at the same time as IFRS 10, then the date of initial application is 1 January 2013.
- IFRS 10.C3E* At the date of initial application, an entity does not need to test whether it qualified as an investment entity before the date of initial application, and does not adjust for any controlled investee disposed of in the comparative period(s).
- IFRS 10.C3B, C6A, IAS 1 (2012).38–38A* Comparative information is restated unless impracticable. However, like IFRS 10, the requirement to present restated comparatives is limited to the immediately preceding period; this corresponds to the minimum requirement for comparative information in IAS 1 *Presentation of Financial Statements*. An entity has the option to leave any further comparative periods unchanged, in which case that fact is disclosed.
- IFRS 10.C3B* The adjustment at the start of the earliest period restated is recognised in equity. At that date, any amounts in OCI related to previous fair value adjustments are transferred to retained earnings.
- IFRS 10.C3C* In determining fair value, IFRS 13 applies for annual periods beginning on or after 1 January 2013 (although early adoption of IFRS 13 itself is also permitted). Therefore, in determining the transitional adjustments, it is likely that IFRS 13 would not yet have been adopted. In that case, the entity uses fair values previously reported to investors or management – but only if those amounts represent the amount for which the investment could have been exchanged between knowledgeable, willing parties in an arm’s length transaction at the date of the valuation. See Section 7 for a discussion of fair value, including the use of net asset value as a practical expedient.
- IFRS 10.C3D* To the extent that the transitional requirements are impracticable, the entity applies them at the beginning of the earliest period practicable.

### Example – Qualifying as an investment entity on adoption

*IFRS 10.B98–B99*

Investment Fund (IF) has consolidated Subsidiary S since its incorporation a number of years ago. IF has a 60% holding in S. IF qualifies as an investment entity and adopts the amendments at the same time as the group of which it is a part adopts IFRS 10 (1 January 2013).

At 1 January 2012 (the start of the preceding comparative period), the following information is relevant.

- The carrying amount of S’s net assets in IF’s consolidated financial statements is 1,000 (including any goodwill).
- The carrying amount of NCI in equity is 400.
- The fair value of IF’s 60% holding in S is 1,500.
- A credit of 150 (net of the amount attributed to NCI) is recorded in a revaluation reserve related to S’s offices, which are measured on a fair value basis in accordance with IAS 16.

IF records the following entry at 1 January 2012.

|   | <i>Debit</i> | <i>Credit</i> |
|---|--------------|---------------|
| Investment in S   | 1,500        |               |
| NCI   | 400          |               |
| Revaluation reserve   | 150          |               |
| Retained earnings (Note)  |              | 1,050         |
| Various assets and liabilities                                  |              | 1,000         |
| <i>To deconsolidate S on qualifying as an investment entity</i> |              |               |

*IFRS 10.C3B*

Note

The debit in the revaluation reserve is transferred directly to retained earnings. Therefore, the amount recognised in retained earnings in this example is the transfer of the revaluation reserve (150) plus the difference between the previous carrying amount of S and its fair value at 1 January 2012, adjusted for NCI (1,500 + 400 - 1,000).

*IAS 8.28(f)*

If the initial application of a standard affects the financial statements, then unless impracticable, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires entities to quantify and disclose, for the current period and *each* comparative period presented, the impact on:

- each financial statement line item affected; and
- basic and diluted earnings per share.

*IFRS 10.C2A*

Like IFRS 10, the amendments provide relief from this general principle. The impact of adopting the standards needs to be quantified only for the immediately preceding period – not for the current period or any additional comparative periods.

### Insight – Adoption as early as 31 December 2012

The language used in the amendments and the accompanying basis for conclusions implies that the IASB expected any investment entities early adopting the amendments to do so for annual periods beginning on or after 1 January 2013 – i.e. at the same time as IFRS 10 and IFRS 12 are adopted.

However, there is nothing in the amendments to restrict adoption as early as 31 December 2012 year ends. For simple investment funds that require little or no analysis under the amendments, this may be desirable. However, such funds will also need to assess the consequential amendments made to standards other than IFRS 10 – e.g. the IFRS 12 disclosures (see Section 8) – to ensure that full compliance is possible in such a short period.

# 11. IFRS compared to US GAAP

The IASB and the FASB undertook joint deliberations in the process of developing the investment entity exception for IFRS, and to improve and clarify the existing guidance in US GAAP.

The FASB is in the process of finalising its deliberations in respect of amendments to US GAAP, and an Accounting Standards Update is expected in the first half of 2013. The following differences are expected.

| IFRS  | US GAAP   |
|---|---|
| No reference to regulatory requirements is included in the definition of an investment entity (see Section 4).  | Unlike IFRS, an entity regulated under the Investment Company Act of 1940 is automatically considered to be an investment company.  |
| A potential exit strategy is required for substantially all investments with an indefinite life (see 4.2).  | Unlike IFRS, potential exit strategies are not expected to be required.   |
| One of the elements of the definition of an investment entity is that substantially all investments are measured, and their performance evaluated, on a fair value basis (see 4.3).   | Unlike IFRS, fair value management – i.e. evaluation of the performance of investments, the way the investment entity transacts with its investors and how the asset-based fees are calculated – is expected to be a typical characteristic of an investment company, rather than an essential element of the definition. |
| In seeking to qualify as an investment entity, a real estate fund follows the same requirements as funds in other sectors. However, the wording of the illustrative example on real estate funds suggests that the IASB intends very few real estate funds to qualify as investment entities (see 4.4). | Unlike IFRS, it is expected that more real estate funds may be considered investment companies.   |
| The consolidation exception extends to the parent of an investment entity that is also an investment entity (see 7.1).  | Unlike IFRS, certain investment company parents are expected to be permitted to consolidate their investment company subsidiaries.  |
| The consolidation exception does not extend to the parent of an investment entity that is not itself an investment entity (see 7.2).  | Unlike IFRS, the consolidation exception is expected to be retained in the consolidated financial statements of a non-investment company parent.  |
| There is no permission to use net asset value as a practical expedient for fair value (see Section 7).  | Unlike IFRS, there is expected to be guidance on computing net asset value per share as a practical expedient for fair value.   |

## About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

### Content

Our *First Impressions* publications are prepared upon the release of a new IFRS, interpretation or other significant amendment to the requirements of IFRS. They include a discussion of the key elements of the new requirements and highlight areas that may result in a change of practice. Examples are provided to assist in assessing the impact of implementation.

This edition of *First Impressions* considers the requirements of *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)*, which was published on 31 October 2012.

The text of the publication is referenced to IFRSs in issue at 1 November 2012; references in the left-hand margin identify the relevant paragraphs.

In many cases, further interpretation may be needed in order for an entity to apply IFRS to its own facts, circumstances and individual transactions. Further, some of the information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change as practice develops.

We will update and supplement the interpretative guidance and examples in this publication by adding additional interpretative guidance to *Insights into IFRS*, our practical guide to IFRS.

### Other ways KPMG member firm professionals can help

A more detailed discussion of the accounting issues that arise from the application of IFRS can be found in our publication *Insights into IFRS*.

In addition, you may find it helpful to visit [kpmg.com/ifrs](http://kpmg.com/ifrs) to keep up to date with the latest developments in IFRS and browse our suite of publications. Whether you are new to IFRS or a current user of IFRS, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as IFRS Newsletters and checklists.

For a sector-specific or local perspective, follow the links to the IFRS resources available from KPMG member firms around the world, which are also available on [kpmg.com](http://kpmg.com). All of these publications are relevant for those involved in external IFRS reporting. The *In the Headlines* series provides a high level briefing for audit committees and boards.

| User need       | Publication series                  | Purpose   |
|-----------------|-------------------------------------|---|
| <b>Briefing</b> | <a href="#">In the Headlines</a>    | Provides a high-level summary of significant accounting, auditing and governance changes together with their impact on entities.  |
|                 | <a href="#">IFRS Newsletters</a>    | Highlights recent IASB and FASB discussions on the financial instruments, insurance, leases and revenue projects. Includes an overview, an analysis of the potential impact of decisions, current status and anticipated timeline for completion. |
|                 | <a href="#">The Balancing Items</a> | Focuses on narrow-scope amendments to IFRS.   |
|                 | <a href="#">New on the Horizon</a>  | Considers the requirements of due process documents such as exposure drafts and provides KPMG's insight. Also available for specific sectors.   |
|                 | <a href="#">First Impressions</a>   | Considers the requirements of new pronouncements and highlights the areas that may result in a change in practice. Also available for specific sectors.   |

| User need                           | Publication series                                | Purpose  |
|-------------------------------------|---|--|
| <b>Application issues</b>           | <a href="#">Insights into IFRS</a>                | Emphasises the application of IFRS in practice and explains the conclusions that we have reached on many interpretive issues.  |
|                                     | <a href="#">Insights into IFRS: An overview</a>   | Provides a structured guide to the key issues arising from the standards.  |
|                                     | <a href="#">IFRS Practice Issues</a>              | Addresses practical application issues that an entity may encounter when applying IFRS. Also available for specific sectors.   |
|                                     | <a href="#">IFRS Handbooks</a>                    | Includes extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard.  |
| <b>Interim and annual reporting</b> | <a href="#">Illustrative financial statements</a> | Illustrates one possible format for financial statements prepared under IFRS, based on a fictitious multinational corporation. Available for annual and interim periods, and for specific sectors. |
|                                     | <a href="#">Disclosure checklist</a>              | Identifies the disclosures required for currently effective requirements for both annual and interim periods.  |
| <b>GAAP comparison</b>              | <a href="#">IFRS compared to US GAAP</a>          | Highlights significant differences between IFRS and US GAAP. The focus is on recognition, measurement and presentation; therefore, disclosure differences are generally not discussed.             |
| <b>Sector-specific issues</b>       | <a href="#">IFRS Sector Newsletters</a>           | Provides a regular update on accounting and regulatory developments that directly impact specific sectors.   |
|                                     | <a href="#">Application of IFRS</a>               | Illustrates how entities account for and disclose sector-specific issues in their financial statements.  |
|                                     | <a href="#">Accounting under IFRS</a>             | Focuses on the practical application issues faced by entities in specific sectors and explores how they are addressed in practice.   |
|                                     | <a href="#">Impact of IFRS</a>                    | Provides a high-level introduction to the key IFRS accounting issues for specific sectors and discusses how the transition to IFRS will affect an entity operating in that sector.                 |

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