

# Summary of recent IASB and Interpretations Committee discussions on the investment entity exception

## What you need to know

- ▶ If a parent does not qualify as an investment entity, it must consolidate all of its subsidiaries, even if they are held by an intermediate holding company that does qualify as an investment entity.
- ▶ A parent that qualifies as an investment entity must not consolidate its subsidiaries, except for those that solely provide investment-related services; all other subsidiaries, including any intermediate holding companies, must be accounted for at fair value through profit or loss.

## Overview

The International Accounting Standards Board (the IASB) and the IFRS Interpretations Committee (the Interpretations Committee) have held recent discussions on the investment entity exception amendment to IFRS 10 *Consolidated Financial Statements*. In this publication, we summarise the IFRS 10 investment entity exception available to the parent of a group in its consolidated financial statements, the outcomes of recent discussions and how they apply to the investment entity parent.

## The investment entity exception

The IASB issued an amendment to IFRS 10 *Consolidated Financial Statements* in October 2012, to introduce an exception from consolidation of investments in subsidiaries by entities that qualify as investment entities. Such entities must not consolidate their subsidiaries; instead those subsidiaries must be accounted for at fair value through profit or loss. The standard defines an investment entity as one that:

- ▶ Obtains funds from one or more investors for the purposes of providing those investors with investment management services
- ▶ Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both
- ▶ Measures and evaluates the performance of substantially all of its investments on a fair value basis

Most investment entities will be in the fund management industry, including private equity and venture capital funds.

The standard also sets out the following four typical characteristics of an investment entity to be considered alongside the definition, although the absence of any one of these does not necessarily disqualify an entity from being classified as an investment entity:

- ▶ It has more than one investment
- ▶ It has more than one investor

Investment entities must record their investments at fair value through profit or loss.



- ▶ It has investors that are not related parties of the entity
- ▶ It has ownership interests in the form of equity or similar interests

An investment entity may also provide investment-related services to third parties, investees and investors and it may provide financial assistance to investees.

### Application by the parent of a group

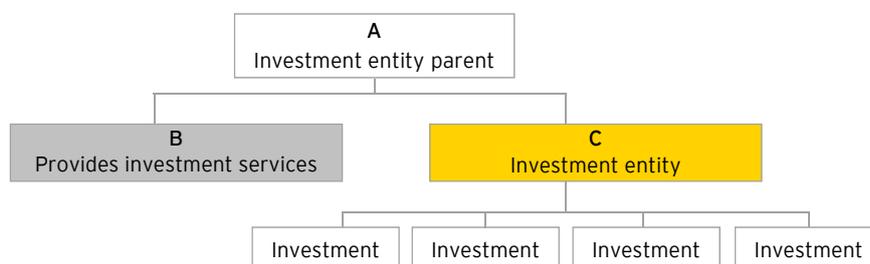
It should be noted that, unlike under US GAAP, the parent of an investment entity only obtains the benefit of the exception in its consolidated financial statements if the parent, itself, meets the definition of an investment entity. If the parent is not an investment entity, it must consolidate all of its subsidiaries. If the parent meets the definition of an investment entity, it *must* apply the exception. This is an exception, and is not an exemption or choice of accounting policy.

The standard also includes the following accounting treatment by the parent of a group which has one or more investment entities:

1. If a parent that meets the definition of an investment entity has an investment in an investment entity subsidiary that is formed only for legal, regulatory, tax or similar business purposes, the parent must fair value its investment in that entity.
2. If a parent that meets the definition of an investment entity has an investment in a subsidiary that provides investment-related services, it must consolidate that subsidiary.

In applying these principles to the organisation structure shown in Figure 1, parent A will consolidate subsidiary B because subsidiary B provides investment-related services. The parent will account for subsidiary C at fair value because subsidiary C is an investment entity. Subsidiary C's investments will therefore not be separately recorded in parent A's consolidated financial statements.

**Figure 1**



#### How we see it

The consequences of applying these principles are:

- ▶ If subsidiary C has borrowings or non-controlling equity investors, these will not be recorded in parent A's consolidated financial statements.
- ▶ Both realised gains on the sale of investments by subsidiary C and any investment income it earns will be hidden within the unrealised gains reported in parent A's consolidated accounts, until a distribution is made by subsidiary C to parent A.

The group structure will affect reported results. Many entities may wish to provide additional information in their financial reports to help explain their performance.

### Recent discussions by the Interpretations Committee and the IASB

Some constituents have observed that there is a degree of potential conflict between principles 1 and 2, as set out above. To resolve these potential conflicts, the Interpretations Committee has examined the following two issues:

The parent of an investment entity only obtains the benefit of the exception in its consolidated financial statements if the parent, itself, meets the definition of an investment entity.

The IASB tentatively decided to amend IFRS 10 to confirm that all investment entity subsidiaries should be measured at fair value through profit or loss, including investment entity subsidiaries that also provide investment services.

**Should intermediate holding companies, which are established for tax optimisation purposes, be consolidated or fair valued by an investment entity parent?**

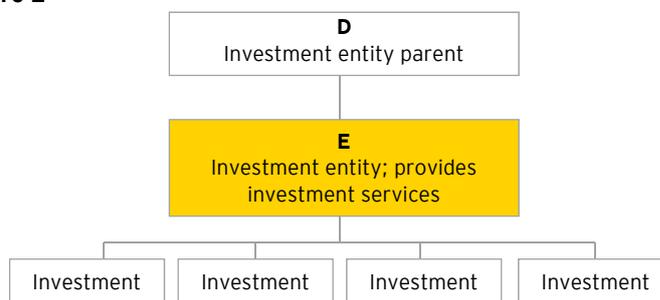
At its meetings in November 2013 and March 2014, the Interpretations Committee noted that one of the typical characteristics of such intermediate holding companies is that they have no activities. If the intermediate parent does not have any activities, the subsidiary would not be considered to provide investment services and, consequently, would not be consolidated. The Interpretations Committee therefore published an agenda decision stating that such intermediate holding companies should be accounted for at fair value by their investment entity parent.

**Should an investment entity parent consolidate or fair value a subsidiary that meets the definition of an investment entity and also provides investment services?**

In January 2014, the Interpretations Committee determined that the parent should account for such a subsidiary at fair value. The Interpretations Committee felt that this conclusion was clear, based on its reading of IFRS 10 with respect to subsidiaries providing investment-related services to investees and investors. However, it recommended that IFRS 10 should be amended to make this clear for subsidiaries providing investment-related services to third parties. At its April 2014 meeting, the IASB tentatively decided to amend IFRS 10 to confirm that an investment entity parent should measure all investment entity subsidiaries at fair value through profit or loss, including investment entity subsidiaries that also provide investment services. The effective date for this amendment has not yet been discussed.

In Figure 2, investment entity parent D would need to fair value subsidiary E in its consolidated financial statements.

**Figure 2**



**How we see it**

The consequences of the Interpretation Committee and IASB discussions are:

- ▶ Subsidiary E will need to record investment-related activities at fair value, including the investment services business and the property and other assets used to support the business. This may not only be a challenge to determine the fair value, but would result in future investment services income being recognised as part of this valuation, rather than when it is earned.
- ▶ In the simple example shown in Figure 2, with the exception of any other activities of parent D (such as management), the fair value of parent D’s investment in subsidiary E would be similar to parent D’s own market capitalisation, meaning that the financial statements may not be very informative unless parent D provides additional information about the performance of subsidiary E.

Entities may wish to provide further information in their financial reports to help explain their performance.

The Interpretations Committee did not publish its conclusion as an agenda decision. This clarification by the Board requires IFRS 10 to be amended. Therefore, we believe that the requirement to record an investment entity, that also provides investment services, at fair value through profit or loss will not be mandatory until the effective date of the amendment.

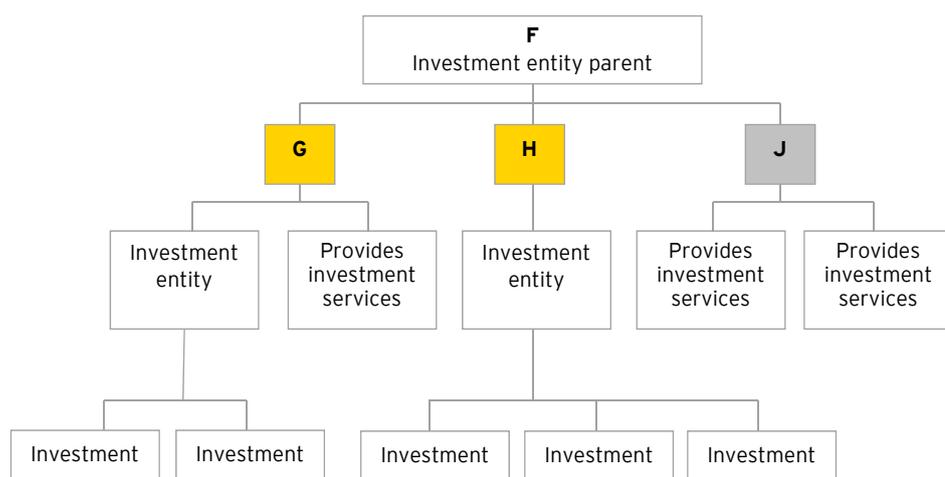
## What remains unclear

Despite the Interpretation Committee's discussions to date, the following issues remain unclear:

- ▶ If a subsidiary of an investment entity parent acts as an intermediate holding company for subsidiaries that provide investment-related services only, should that intermediate holding company be consolidated or recorded at fair value?
- ▶ If an intermediate holding company between an investment entity parent and the underlying investees would not itself satisfy the criteria to be treated as an investment entity (because, for instance, it does not measure and evaluate the performance of its investments on a fair value basis), should that intermediate holding company be consolidated or fair valued?

Based on the past discussions of the IASB, we believe that it is the IASB's view that an investment entity parent should only consolidate an intermediate holding company if it holds investments only in subsidiaries that solely provide investment-related services. Any intermediate holding company that has holdings, whether directly or indirectly, in the underlying investments, should be recorded at fair value through profit or loss. Following this, in Figure 3, parent F would need to record subsidiaries G and H at fair value, while subsidiary J and its subsidiaries would be consolidated.

**Figure 3**



### How we see it

If the IASB decides to clarify that its position is consistent with the views above, fund management groups may wish to reorganise their structures so as to avoid having 'mixed activity' intermediate holding companies such as subsidiary G. Instead, all investment-related services would be provided by intermediate holding companies such as subsidiary J, that do not themselves hold underlying investments.

Entities may also wish to provide further information in their financial reports to explain their results.

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