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IFRS Developments

Investment entities — the plot thickens

What you need to know

The following are tentative decisions made by the IASB at the May and June 2012 meetings:

- An entity is no longer required to meet six criteria in order to qualify as an investment entity
- An entity must now meet a definition using some of the originally proposed criteria, and consider the remaining originally proposed criteria as factors or indicators, in its assessment of whether it qualifies as an investment entity
- An investment entity should measure all controlling financial interests in another investment entity at fair value (including in both master-feeder and fund-of-funds structures)
- Non-investment entity parents of investment entities are not permitted to retain the fair value accounting that the investment entity subsidiary applies to its controlled investees
- Investment entities are required to measure their investments in associates and joint ventures at fair value through profit or loss, except for their investments in associates and joint ventures *which provide services to the investment entity*, which must be accounted for using the equity method of accounting
- For non-investment entities, the existing option in IAS 28 to measure investments in associates and joint ventures at fair value through profit or loss will be retained

Background

In 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (collectively, the Boards) issued exposure drafts (EDs) on the proposals for investment entities. The comment period for the EDs ended in early 2012. The Boards then ran four round-table meetings through February and March, gathering views from constituents in a number of jurisdictions. In April 2012, at the joint meeting between the IASB and the FASB, the Boards discussed a summary of the comments received on both EDs in an education session, where no decisions were made. The tentative decisions made by the Boards in the May and June 2012 meetings are discussed below.

A definition replaces the six criteria

In May 2012, the Boards met to begin to redeliberate the proposals in the EDs in light of the feedback received from constituents. At this meeting, the Boards discussed the six criteria to be met in order for an entity to qualify as an investment entity, and the associated application guidance. The Boards tentatively decided that, instead of having criteria, they would define an investment entity and provide additional factors (or indicators) that an entity would need to consider, in determining whether the entity met the definition.

The tentative definition of an investment entity is as follows:

1. An investment entity does **all** of the following:
   a. Obtains funds from an investor or investors and provides the investor(s) with professional investment management services
   b. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds for returns from capital appreciation or capital appreciation and investment income
   c. Manages and evaluates the performance of substantially all of its investments on a fair value basis
2. An investment entity and its affiliates **do not** obtain, or have the objective of obtaining, returns or benefits from their investments that are either of the following:
   a. Other than capital appreciation or capital appreciation and investment income

   Or

   b. Not available to other non-investors or are not normally attributable to ownership interests

The Boards noted that it was still unclear as to how the definition and the factors will interact in making the assessment of whether an entity qualifies as an investment entity.

The FASB tentatively decided to have the same definition as the IASB, with some differences, such as excluding 1c in the definition of an investment entity. Due to the many concerns raised in the US about the concept of fair value management and the difference in the understanding of the concept between the IASB and the FASB, the FASB tentatively decided that fair value management (as described in its ED) would be a factor for the entity to assess, rather than a mandatory concept that forms part of the definition. That assessment would consider how the entity manages and evaluates the performance of its investments, how the entity transacts with its investors, and how asset-based fees are calculated to determine whether the entity manages its investments on a fair value basis.

Factors to consider alongside the definition

The Boards also tentatively decided that an entity should consider the following factors to determine whether it qualifies as an investment entity:

- The number of investments held by the entity, and the number of investors it has
- Whether the investors are related to each other and to the parent of the investment entity (if there is a parent)
- The type of ownership interests – in the equity or in the debt of the entity

The Boards noted that it was still unclear as to how the definition and the factors will interact in making the assessment of whether an entity qualifies as an investment entity, e.g. if an entity meets the definition, but has only one investment and one investor, would it still qualify as an investment entity? The staff agreed to include a paper further discussing this issue at a future joint meeting.

The Application Guidance – clarifications proposed

The Boards tentatively decided to revise the application guidance in the EDs, as follows:

- Transactions between controlled investees would be permitted
- The entity may be, but does not have to be, a legal entity
- Investment entities are not required to be set up at the same time to apply the guidance relating to whether they are formed in conjunction with each other
- An entity is permitted to set up a single investor or single investment funds alongside a main fund for various business reasons, other than legal, regulatory or tax reasons, provided the funds meet the definition of an investment entity

The IASB's guidance was expanded to include the following clarifications (the FASB's proposals already included similar guidance on these topics):

- An investment entity would be allowed to provide investment-related services to third parties, provided those services are not substantive.
- Involvement in the day-to-day management of investees would not disqualify an entity from being an investment entity.
- An investment entity would be required to have an exit strategy for substantially all of its investments. However, the exit strategy assessment would be performed at a portfolio level.
- In a master-feeder structure, the master fund would be required to meet the exit strategy requirements in order for the feeder fund to meet the exit strategy requirement.
- An entity is not required to measure its financial liabilities at fair value, and manage them on a fair value basis, in order to qualify as an investment entity.

In addition, the IASB decided that it would not include guidance regarding consideration of how an entity transacts with its investors and how asset-based fees are calculated in determining whether the entity manages its investments on a fair value basis.

How we see it

Most of the issues in the Application Guidance discussed above were highlighted in our comment letter to the IASB as needing clarification, so we broadly welcome the proposed wording amendments. However, some companies would meet the definition of an investment entity, if it were not for the investment services they provide to third parties. To this end, we think there will be uncertainty about what the IASB means by 'substantive', which is not defined in these proposals or in any other IFRS. This could lead to diversity in practice.

Accounting by an investment entity parent for an investment entity subsidiary

At the June 2012 joint Board meeting, the Boards tentatively decided that an investment entity should measure all controlling financial interests in another investment entity at fair value (including in both master-feeder and fund-of-funds structures), and should not consolidate those subsidiaries.

The FASB additionally decided to require a feeder fund to attach its master fund's financial statements along with its financial statements in a master-feeder structure. The FASB will discuss at a future FASB meeting whether a master-feeder structure should be defined. The IASB decided not to require an investment entity to attach the financial statements of its investees in any circumstances.

The FASB will discuss at a future FASB-only meeting whether a investment company parent entity that is regulated under the SEC's *Investment Company Act* of 1940 should be required to consolidate its wholly-owned investment company subsidiaries.

To roll-up, or not to roll-up – accounting by a non-investment entity parent for an investment entity subsidiary

The IASB tentatively decided that **a non-investment entity parent should not retain (or roll-up)** the exception from consolidation used for the controlled investees of an investment entity subsidiary. The FASB tentatively decided to retain the requirement in current US GAAP that **a non-investment company parent should retain** the fair value accounting used by an investment company subsidiary. Both of these decisions are consistent with the proposals in the respective EDs.

How we see it

The staff noted in their agenda paper for this meeting that there was broad support in the comment letters for roll-up. Despite this, the IASB continues to have concerns around abuse if it allows roll-up. The concerns mainly relate to structuring transactions, where a parent could potentially achieve specific accounting outcomes by transferring controlled investments into an investment entity subsidiary. The definition and factor approach to assessing whether an entity was an investment entity, instead of applying the six criteria as presented in the ED, contributed to this concern, as the population of entities that could potentially apply the exception from consolidation is broader than was originally anticipated when the project began.

The proposed consequential amendment to IAS 28

The IASB discussed the interaction of the proposals with IAS 28 (as amended in 2011), and tentatively decided the following:

- Investment entities should be required to measure their investments in associates and joint ventures at fair value through profit or loss, except for their investments in associates and joint ventures *which provide services to the investment entity*, which should be required to be accounted for using the equity method of accounting
- For non-investment entities, the existing option in IAS 28 to measure investments in associates and joint ventures at fair value through profit or loss will be retained.

How we see it

We welcome the move to retain the existing option in IAS 28 to measure associates or joint ventures at fair value through profit or loss or using the equity method, for entities that do not meet the definition of investment entities (such as venture capital organisations, mutual funds and similar entities). There was no given rationale as to why this was proposed, and we had strongly recommended in our comment letter that the option be retained.

Next steps

The Boards will continue to debate the investment entities proposals over the next few months. As the exception from consolidation will be in the form of an amendment to IFRS 10, the IASB noted that it is important for it to complete the redeliberations as soon as realistically possible, given the effective date of 1 January 2013 for IFRS 10. The latest work plan of the IASB states that the 'target IFRS' is expected in the second half of 2012.

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