

Proposal for investment entities to measure investments at fair value

What you need to know

- ▶ The Boards are proposing to broadly align the accounting for investment entities.
- ▶ Comments are due by 5 January 2012.
- ▶ To be an investment entity, an entity would be required to meet several criteria.
- ▶ Investment entities would be prohibited from consolidating investments in controlled entities.
- ▶ Investment entities would be required to measure all controlled investments at fair value through profit or loss (the equity method would not be permitted).
- ▶ The IASB proposes that a parent of an investment entity that is not an "investment entity" itself would be required to consolidate any controlled investees held by the investment entity (that is, fair value is not allowed at the parent entity level).
- ▶ Conversely, the FASB's expected proposal would allow the parent to retain the "investment entity's" fair value accounting, even if the parent is not an investment entity.
- ▶ Entities that are currently permitted to measure investments in joint ventures or associates at fair value through profit or loss under IAS 28 *Investments in Associates and Joint Ventures*, but that do not meet the definition of an investment entity, would no longer be able to use fair value through profit or loss to account for such investments.
- ▶ Early adoption would be permitted, with certain conditions.

On 25 August 2011, the International Accounting Standards Board (IASB) published an Exposure Draft (ED), *Investment Entities*, that proposes an exception to the principle in IFRS that an entity consolidates all controlled entities. Instead, the ED would **require** an investment entity (as defined) to measure all controlled investments at fair value, with changes recognised in profit or loss. This proposed exception helps address what many in the asset management and private equity industries, and users of their financial statements, believe is a significant problem with the current consolidation requirements in IFRS.

As a part of the deliberations ultimately leading to the issue of IFRS 10 *Consolidated Financial Statements*, the IASB received many letters noting that for "investment entities", rather than enhancing decision-useful information, consolidating the controlled investment actually obscures such information. This feedback was persuasive and, together, the IASB and the Financial Accounting Standards Board (FASB) (collectively, the Boards) developed a proposal for a converged definition of an investment entity, which is based on the definition under current US GAAP and other non-authoritative guidance. If finalised, this ED would amend the requirements of IFRS 10 to require investment entities to measure all controlled investments at fair value. Coupled with the FASB's proposed modifications to US GAAP's definition of an investment entity (an investment company under US GAAP), this proposal represents a significant step towards aligning IFRS and current US GAAP for investment entities.

Key principles

The ED proposes that an investment entity would be required to measure all investments in controlled entities at fair value through profit or loss.

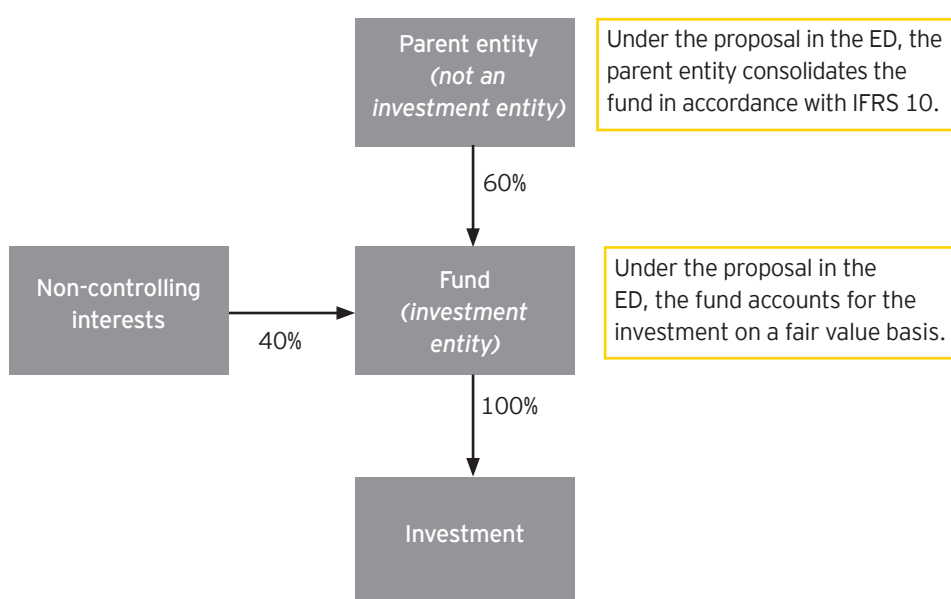
How we see it

Preparers and users of financial statements of investment entities have previously indicated that an exemption from consolidating controlled investees would be beneficial, because they believe that measuring such investments at fair value results in more decision-useful financial reporting. Therefore, we anticipate there will be broad support for the proposals. However, it should be noted that not all users share this view and that some would prefer to retain the consolidation requirements.

Accordingly, perhaps consideration should be given to provide an accounting policy choice to entities that meet the criteria to be an investment entity, but who have determined, based on an assessment of their facts and circumstances, that consolidation would provide more decision-useful information, to consolidate their controlled entities.

However, a parent of an investment entity would consolidate all entities it controls, including those controlled through a subsidiary that is an investment entity, unless the parent itself is an investment entity (see diagram). This is expected to be one of the main differences between the FASB and IASB proposals. The FASB's expected proposal would continue to allow the parent to retain the investment entity's fair value accounting, even if the parent is not an investment entity. Under both proposals, the investment entity (e.g., a fund) would account for its controlled investments at fair value in its own financial statements. The IASB has specifically asked for comments on this issue.

In its Basis for Conclusions to the ED, the IASB raised a concern that a parent not meeting the criteria to be an investment entity would use the exemption, even though the controlled investments are integral to the group's business as a whole. For this reason, the IASB proposed the accounting described above – to prevent abuse.



Definition of investment entity

The table below lists the ED's criteria that an entity must meet to be considered an investment entity. When commenting on the ED and planning for implementation

(if the proposal is finalised), respondents should consider how the criteria can be practically implemented, based on their facts and circumstances.

How we see it

If the criteria to be an investment entity are properly defined, some would consider it appropriate that the parent of an investment entity that is not an investment entity should be able to retain the fair value accounting applied by its subsidiary qualifying as the investment entity in the parent's consolidated financial statements (consistent with the FASB proposal). Proponents of this view generally believe that if fair value provides the most decision-useful information in the financial statements of the investment entity, it also provides the most decision-useful information in the group's financial statements.

Furthermore, proponents of the FASB proposal generally believe that it would be unlikely that a conglomerate and its subsidiaries would be an investment entity. Additionally, proponents of the FASB approach believe that the FASB and IASB should converge on this point.

Criteria	Description in ED
Nature of investment activity	The entity's only substantive activities are investing in multiple investments for capital appreciation, distributions (such as dividends or interest), or both.
Business purpose	The entity makes an explicit commitment to a group of investors that the purpose of the entity is investing to provide returns from capital appreciation, distributions (such as dividends or interest), or both. To meet this criterion, an entity would need to have an exit strategy (to realise any benefits from capital appreciation).
Unit ownership	Ownership in the entity is represented by units of investments, such as ordinary shares or partnership interests, to which proportionate shares of net assets are attributed.
Pooling of funds	The funds of the entity's investors are pooled to avail the investors of professional investment management. The entity has investors who are unrelated to the <i>investment entity's</i> parent (if any) and, in the aggregate, hold a significant ownership interest in the entity.
Fair value management	Substantially all of the investments of the entity are managed, and their performance evaluated, on a fair value basis. IFRS 13 <i>Fair Value Measurement</i> defines "fair value" and describes how to measure fair value.
Provides financial information	The entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity.

Impact on joint ventures and associates

As a consequential amendment, the IASB is proposing changes to the accounting for joint ventures and associates.

Under current IFRS, venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities have a choice as to whether to use fair value through profit or loss, or the equity method. The IASB is proposing to remove this choice. Investment entities (as defined) will be required to measure investments in associates and joint ventures at fair value through profit or loss. This is because one of the criteria to be an investment entity is that substantially all of the investments of the entity are managed, and their performance evaluated, on a fair value basis. This requirement applies to investments in joint ventures and associates as well – not just entities in which the investment entity has a controlling interest.

A parent of an investment entity would be required to use fair value to measure the investment entity's investments in joint ventures and associates, even though the IASB would not allow the parent to measure the investment in a subsidiary at fair value (as discussed above).

Entities that do **not** meet the definition of an investment entity, but are currently permitted to measure investments in joint ventures or associates at fair value under IAS 28, would no longer be able to use fair value through profit or loss. Such entities would be required to use the equity method to measure their investments in associates and joint ventures. This could be a significant change for certain venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities, if they do not meet the criteria to be an investment entity.

How we see it

Consideration could be given as to whether requiring more entities to use the equity method provides decision-useful information, given the questions that currently exist about the equity method. It would perhaps be better not to prohibit entities that are currently using fair value from doing so, and not change the wording or choice available in IAS 28, until the equity method is on the IASB's agenda.

If the IASB decides to allow both an investment entity parent and non-investment entity parent to retain fair value accounting on consolidation, it is reasonable to require the parent (in both cases) to use fair value accounting for the investment entity's investments in joint ventures and associates.

However, if the IASB proceeds as proposed in the ED (a non-investment entity parent cannot retain fair value accounting on consolidation), perhaps a parent should have a choice as to whether to measure investments in joint ventures or associates at fair value.

Practical expedient

One concept that is not included in the ED is a proposal that investment entities, as defined, could use a practical expedient and measure the fair value of their investments using net asset value (NAV), if this information is provided by an investment fund.

US GAAP currently requires an investment entity to recognise its underlying investments at fair value at each reporting period, and provides a practical expedient that permits an entity with an investment in an investment entity to use NAV, without adjustment, as fair value in specific circumstances. When the IASB discussed whether to include a similar practical expedient when issuing IFRS 13 *Fair Value Measurement*, the IASB decided that it would be difficult to identify when such a practical expedient could be applied, given the different practices for calculating NAV globally. The IASB noted that investment entities might prepare their financial

statements (and NAV) in accordance with other GAAP, which might differ from the amounts that would be calculated in accordance with IFRS. Accordingly, the IASB decided at this time not to permit a practical expedient under IFRS. This would be an area of difference between US GAAP and IFRS.

How we see it

Constituents should consider whether they believe the IASB should add this practical expedient to IFRS, once investment entities are defined, and consider commenting on this point to the IASB in their response.

Disclosures

The ED proposes to require significant disclosures, including the following:

- ▶ Information to enable users to evaluate the nature and financial effects of the entity's investment activities
- ▶ Effect of any changes in status as an investment entity
- ▶ Financial or other support provided to controlled investments
- ▶ Nature and extent of any significant restrictions on the ability of controlled investees to transfer funds to the investment entity

An investment entity would still be required to comply with the disclosure requirements of other IFRS. For example, in accordance with IFRS 13, an investment entity would be required to disclose the fair value for each material investment using the fair value hierarchy (including the methodology and inputs used to determine fair value).

The ED does **not** propose to exempt investment entities from the disclosures required by IFRS 12, which requires an entity to disclose summarised financial information for:

- ▶ Controlled investees for which the non-controlling interest is material
- ▶ Individually material joint ventures and associates (separately for each)
- ▶ Immaterial joint ventures in the aggregate, but separately from immaterial associates

How we see it

Consideration should be given as to whether **all** of the summarised financial information required by IFRS 12 is necessary, especially since the fair value of investments and the inputs into those fair values are required to be disclosed. Perhaps such financial information should be permitted to be based on the controlled investment's financial statements (which might have a different accounting-period end, different accounting policies, or be prepared on a different GAAP), if providing IFRS financial statements consistent with the investment entity's accounting policies would cause undue cost. This is consistent with the relief granted for joint ventures and associates currently in IFRS 12, when the fair value option is used by venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities.

If the IASB were to allow investment entities an accounting policy choice with respect to controlled investments, it could consider whether to require disclosure of fair value for such investments.

Transition

The ED proposes that, if an entity meets the definition of an investment entity, it recognises the effect of adopting the measurement exception as of the beginning of the period that it first applies the proposed IFRS, as an adjustment to opening retained earnings. The adjustment to retained earnings would be for the difference between (1) the previous carrying amount of the net assets of the investee and (2) the fair value of the investee as of the date of first applying the proposed IFRS, adjusted for any changes in the fair value of investees that still remain in accumulated other comprehensive income.

Effective date

The ED does not include an effective date. However, when previously discussed by the IASB, an effective date of 1 January 2013 had been proposed, which coincides with when IFRS 10 becomes effective. This would allow entities to transition only once.

How we see it

Consideration should be given to how long preparers will need to modify their systems and processes to de-consolidate any previously consolidated entities, and to comply with the new disclosure requirements.

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