



cutting through complexity

IFRS

# New on the Horizon: Investment entities

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## Proposals respond to constituent concerns, but do they go far enough?

We welcome the IASB's proposals to amend IFRS 10 *Consolidated Financial Statements* in relation to consolidation requirements for investment entities. The amendments would require qualifying investment funds to recognise their investments in controlled entities in a single line item on the balance sheet, measured at fair value through profit or loss. Currently such investments are consolidated.

The proposals respond to the concerns of constituents who expressed support for a consolidation exception for investment funds in comment letters during the development of IFRS 10. US GAAP already has a somewhat similar exception, and some investment funds, particularly in the private equity sector, have historically been choosing US GAAP or other local GAAP over IFRS to achieve fair value accounting for investments when such a reporting framework choice was available. The proposals could encourage qualifying investment funds to switch to IFRS.

The proposals would significantly reduce the difference between IFRS and US GAAP in this area. A FASB Proposed Accounting Standards Update, due for release in the near future, is expected to be largely the same as the IASB's proposals. However, key differences are expected to remain. In particular, the IFRS proposals do not extend to the parent of an investment entity that is not itself an investment entity; we do not expect the FASB proposals to be restricted in this way and the consolidation exception is expected to carry through to the parent. In addition to continuing a GAAP difference, this means that in many cases the cost saving will be lost under IFRS because consolidation will still be required, just at a higher level.

Another area for careful consideration is whether the scope of the exception achieves the right balance between providing only limited relief from consolidation and not being drafted too restrictively. The private equity sector and real estate funds in particular should pay attention to the criteria to qualify as an investment entity.

We hope that this publication will assist you in gaining a greater understanding of the proposals as you work towards your comment letter by the due date of 5 January 2012.

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# 1. Highlights

The IASB published ED/2011/4 *Investment Entities* on 25 August 2011. The amendments to IFRS 10 would require investment entities (as defined) to measure their investments in controlled investees at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*, rather than consolidating those investments.

## Overview of the proposals

- Investment entities would measure investments in controlled investees at fair value through profit or loss.
- The consolidation exception would not be carried through to a parent that is not itself an investment entity.
- An investment fund would qualify as an investment entity only if all of the following criteria are met.
  - **Activities.** The fund's only substantive activity is to invest in multiple investments for capital appreciation and/or investment income; it has made an explicit commitment to investors that this is the purpose of its activities; and it reports financial information about these activities to investors.
  - **Investors.** The fund issues units that represent an entitlement to a proportionate share of net assets; investors are pooled to gain access to professional investment management services; and a significant portion of the units are held by investors unrelated to the parent of the fund (if any).
  - **Fair value management.** Substantially all investments of the fund are managed, and their performance evaluated, on a fair value basis.
- Investment entities would measure investments in associates and interests in joint ventures at fair value through profit or loss. This measurement exception would be carried through to the parent (investor) that is not itself an investment entity. This would be a change from the existing fair value option for venture capitalists and similar entities.
- Additional disclosure requirements would be introduced.
- Changes in status would be accounted for prospectively.

The IASB's proposals are out for consultation until 5 January 2012, with any final amendments likely to take effect in 2013, at the same time as IFRS 10, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities* and IAS 28 (2011) *Investments in Associates and Joint Ventures*.

## 2. How this could affect you

Key impacts	
<b>Aligning internal and external financial reporting</b>	<p>The IASB initiative of replacing consolidation with fair value accounting is another step in aligning the way in which investments are managed and their performance evaluated internally with external financial reporting. This could be a significant, positive change compared with the current position under IFRSs.</p>
<b>Unique sector approach could bring multiple benefits</b>	<p>The IASB acknowledges that this investment funds-related exposure draft is a deviation from its usual policy of focusing on the substance of transactions and avoiding industry-specific requirements. However, in this instance the sector approach could bring multiple benefits, and might see more investment funds adopting IFRSs to the extent that they have a choice.</p> <ul style="list-style-type: none"> <li>• Investors and other users of the financial statements could receive more useful and meaningful financial information, as net assets attributable to unitholders would be calculated based on the fair value of investments, typically in line with information included in the prospectus.</li> <li>• Some investors argue that the IFRS 7 <i>Financial Instruments: Disclosures</i> and IFRS 13 <i>Fair Value Measurement</i> disclosures for financial instruments at fair value through profit or loss present more relevant information for investors, compared with the disclosures for consolidated investees.</li> <li>• The administrative burden and the cost of reporting would be reduced as obtaining and consolidating information about individual assets, liabilities, income and expenses from controlled investees typically is more onerous for an investment fund than estimating the fair value of such investments.</li> </ul>
<b>Parent of an investment entity may still need to consolidate</b>	<p>The consolidation exception would not extend to any parent of an investment entity that is not itself an investment entity. This means that in many cases the cost saving will be lost because consolidation will still be required, just at a higher level. Interestingly, the US GAAP proposals, currently being finalised, are expected to extend to the parent in such cases.</p>
<b>Not all investment funds would qualify, with real estate funds and some private equity funds particularly at risk</b>	<p>Not all investment funds would qualify for the exception, which means that funds should carefully consider the proposals against their specific circumstances.</p> <ul style="list-style-type: none"> <li>• Private equity funds probably have the highest expectation of benefiting from the consolidation exception. However, it is not clear from the proposals whether the IASB has fully considered the potential range of private equity activities: from the appointment of the directors of the controlled investee, which would be usual; to more active involvement in helping to integrate or restructure operations.</li> <li>• At first glance, it appears that it will be very difficult for real estate funds to qualify as investment entities, partly because of the range of activities often undertaken with respect to the operations of controlled investees; and partly because of the basis on which investees are managed (see below).</li> <li>• Many funds, particularly in the real estate sector, manage the underlying assets of a controlled investee on a fair value basis but not any liabilities. Such an approach appears to rule out investment entity status.</li> </ul>

### 3. A joint project with the FASB

Consolidation, including a consolidation exception for investment entities, is one of the priority projects identified in the Memorandum of Understanding (MoU) between the IASB and the FASB in their *Roadmap for Convergence between IFRSs and US GAAP*.

In working towards completion of the MoU, the IASB and the FASB worked separately on improving their respective consolidation standards. This culminated in the issue of IFRS 10 and IFRS 12 by the IASB in May 2011, and the issue of Statement No. 167 *Amendments to FASB Interpretation No. 46(R)* by the FASB in June 2009.

A remaining part of the consolidation project in the MoU was a consolidation exception for investment entities. US GAAP has historically had a somewhat similar exception, but there has been no such relief under IFRSs. Originally the IASB and the FASB had been expected to release their proposals at the same time; however, delays at the FASB caused the IASB to forge ahead and release its proposals alone. At this stage we expect the two sets of proposals to have the same deadline for comment of 5 January 2012.

Until November 2010 the Boards stated publicly<sup>1</sup> that they expected to achieve convergence in respect of a consolidation exception for investment entities. However, this outcome now appears less likely as the proposals are expected to be different in two key respects (see section 6).

- The IFRS proposals do not extend to the parent of an investment entity that is not itself an investment entity; we do not expect the FASB proposals to be restricted in this way and the consolidation exception is expected to carry through to the parent in such cases.
- The IFRS proposals extend to the parent of an investment entity that is also an investment entity; the FASB proposals are expected to require a parent investment entity to consolidate controlled investees that are themselves investment entities.

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<sup>1</sup> MoU progress report *Progress Report on Commitment to Convergence of Accounting Standards and a Single Set of High Quality Global Accounting Standards*, 29 November 2010

## 4. Aligning internal and external reporting

*ED 6* Investments in the controlled investees (i.e. subsidiaries) of qualifying investment entities would be measured at fair value through profit or loss in accordance with IFRS 9. This accounting, which is straightforward as a concept, would be mandatory; a fund would not have an accounting policy choice in this regard.

As a result, the key areas of focus in the proposals are the criteria to qualify as an investment entity (see section 5) and the application of the exception within a group (see section 6).

*ED BC2, BC3* The IASB noted the concern of constituents who expressed support for a consolidation exception for investment funds during the development of IFRS 10, and agreed that consolidated financial information may not be the most useful information to be reported by investment entities. However, the IASB also acknowledges in the exposure draft that it is deviating from its usual policy of avoiding industry-specific requirements.

For entities able to take advantage of the exception, this initiative is another step by the IASB in aligning external financial reporting with the way in which investments are managed and their performance evaluated internally.

*ED D (IAS 28)* IAS 28 (2011) would be amended so that the current option for venture capital organisations, mutual funds, unit trusts and similar entities (including investment-linked insurance funds) to measure investments in associates and joint ventures at fair value through profit or loss would be replaced by a mandatory measurement exception for investment entities. As a result, measuring investments in controlled entities, associates and joint ventures at fair value through profit or loss would become mandatory for qualifying investment entities.

### Observations – Venture capitalists to reassess

Venture capital organisations and similar entities that have previously applied the fair value measurement option for investments in associates and joint ventures would have to reassess whether they qualify as investment entities. In many cases, this analysis may result in a different scope conclusion because of the strict qualification criteria.

### Observations – Interests in joint ventures

While the proposals envisage an investment entity having interests in joint ventures, this may be an area that requires careful consideration. The concept of a joint venture, effectively based on unanimous consent over substantive operating and business decisions, at first glance appears to be somewhat inconsistent with the activities of an investment entity.

## 5. Not all investment funds would qualify

ED 2

An investment fund would qualify as an investment entity only if all of the following criteria are met.

- **Activities.** The fund's only substantive activity is to invest in multiple investments for capital appreciation and/or investment income; it has made an explicit commitment to investors that this is the purpose of its activities; and it reports financial information about these activities to investors.
- **Investors.** The fund issues units that represent an entitlement to a proportionate share of net assets; investors are pooled to gain access to professional investment management services; and a significant portion of the units are held by investors unrelated to the parent of the fund (if any).
- **Fair value management.** Substantially all investments of the fund are managed, and their performance evaluated, on a fair value basis.

ED 2(f), BC18

An investment entity would not need to be a legal entity. For example, some trusts and partnerships may not be considered legal entities in all countries.

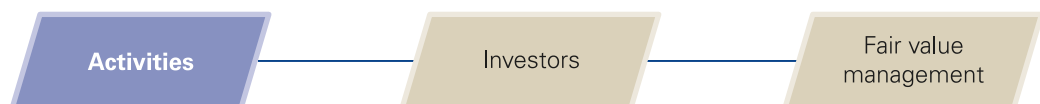
### Observations – Who might be most impacted?

Private equity funds probably have the highest expectation of benefiting from the proposals. Other funds that we expect could be affected by the amendments include:

- real estate funds;
- master-feeder structures, in which a feeder fund has a controlling share in the master fund, but see section 6 for a potential difference with US GAAP;
- investment funds that hold the significant portion of the equity tranche of CDO/CLO<sup>2</sup> or similar vehicles; and
- in some instances, funds of funds, but again see section 6 for a potential difference with US GAAP.

However, there are some significant hurdles discussed throughout this section that require careful consideration, potentially the most critical being the restrictions placed on business activities (see 5.1.1) and the need to manage investments on a fair value basis (see 5.3).

### 5.1 Activities



#### 5.1.1 Business purpose restricted

ED 2(a), B1, B6, B7, BC13

The proposals require that the only substantive activity of an investment entity be to invest for capital appreciation and/or investment income. As a consequence, the proposals note that an investment entity would not have significant assets or liabilities other than for its investing activities. All other activities, such as product or service co-development, production and marketing would be prohibited in qualifying as an investment entity; the only exception would be certain investment advisory services (see 5.1.3). The IASB's intention is that an investment entity should not obtain any benefits from subsidiaries that would be unavailable to other investors.

<sup>2</sup> CDO/CLO: Collateralised debt obligation/Collateralised loan obligation

ED 2(b), B8

Furthermore, an investment entity would need to make an explicit commitment to its investors regarding the above business purpose. This commitment could be included in the prospectus, investor communications and/or other documents.

### Observations – Change in investment strategy

It appears that a change in the detail of a fund's investment strategy would not impact its status as an investment entity, as long as its business purpose remains obtaining returns from capital appreciation, distributions and/or interest.

ED B6

The proposals include the following examples of relationships and activities that would preclude an investment fund from qualifying as an investment entity:

- acquiring, using, exchanging or exploiting intangible assets, technology or processes;
- joint arrangements;
- co-development, marketing or production of products or services;
- exclusive or disproportionate rights to acquire assets, technology, products or services, e.g. an option to purchase an asset from an investee if its development is successful;
- financing guarantees or collateral provided by the investee, although this does not preclude the investment fund from using its investments in investees as collateral for borrowings;
- an affiliate of the investment fund holds an option to purchase ownership interests in the investee; and
- other transactions with terms that are not on an arm's length basis, on terms unavailable to investors that are not related parties, or that represent a significant portion of the business activities of the investee.

ED B6

These activities could be carried out directly between the fund and investee or through affiliates of either.

ED A

The proposals introduce the concept of an affiliate into IFRSs for the first time, as a subset of related parties in IAS 24 *Related Party Disclosures*. An *affiliate* of an entity would be a party that, directly or indirectly through one or more intermediaries, controls or is controlled by the entity, or is a fellow subsidiary of the entity. Therefore, affiliates are parties that are related by virtue of a control relationship, which excludes associates and joint ventures.

### Observations – Affiliate vs related party

Although the proposals introduce the term *affiliate*, in the following cases the proposals revert to related parties:

- in assessing whether transactions are on arm's length terms (see above); and
- in assessing whether the investment fund has multiple investors (see 5.2.2).

Therefore, care will be required in distinguishing between affiliates and related parties in general at different places in the proposals.

### Observations – Questions about the examples

The above examples raise a number of practical questions that may be relevant in responding to the proposals, such as the following.

- What if co-development or co-marketing is done on an arm's length basis? Would this change the status of the investment entity?

At first glance, it appears that co-development or co-marketing on an arm's length basis would preclude investment entity status because there is no mention in the proposals of the basis on which the relationship is conducted.

- What if one of the above criteria is not met for one investment that represents, say, 10 percent of the portfolio? Would this change the status of the investment entity?

Again, at first glance it appears that this would preclude investment entity status because there is no materiality concept built into the criteria. However, it raises questions as to whether an insignificant 'violation' would be acceptable when IFRSs embody an inherent concept of materiality.

- If an investment is tainted such that a fund no longer qualifies as an investment entity, does the fund regain its investment entity status as soon as it disposes of the investment?

The proposals are not clear in this respect. On the one hand, it appears that the fund would regain its investment entity status as soon as it disposes of an investment that causes it to fail the investment entity criteria. On the other hand, it could be argued that having undertaken a prohibited activity in the past would send a general signal about the lack of an explicit commitment to the required business purpose.

### Observations – Private equity-type involvement in operations not addressed

Private equity funds probably have the highest expectation of benefiting from the consolidation exception. However, it is not clear from the proposals whether the IASB has fully considered the potential range of private equity activities and how they might affect qualification.

A private equity fund will, in most situations, appoint the board of directors of the investee through the authority vested in the share capital that it controls. Employees or partners of the fund manager usually will serve as directors of that board, whose activities will include setting the business strategy and approval of business plans and budgets. At the other extreme, the fund may send in staff to help integrate or restructure the operations of the investee on a continuous or repeated basis, for example to do the detailed business planning and handle bank negotiations.

The illustrative example included in the proposals does not address these issues (see 7.2).

#### ED IE3

In addition to the above examples of activities that preclude investment entity status, the illustrative examples (which will not be an integral part of the final amendments) include a real estate partnership whose activities include developing retail properties. On that basis, the example concludes that the real estate partnership is not an investment entity because its activities are not limited to investing for capital appreciation and/or investment income.

#### ED IE3

In the same example, the general partner (which is the parent of the real estate partnership) will manage the retail properties after their development. The example concludes that the general partner is not an investment entity because, in addition to being involved in development (in its capacity as affiliate of the real estate partnership), it is actively involved in the operation of the properties. The example notes that this conclusion is irrespective of whether the terms of the arrangement with the general partner are on an arm's length basis.

### Observations – Status of real estate funds unclear

The wording of the illustrative example in relation to real estate funds suggests that the IASB intends very few real estate funds to qualify for investment entity status. In our experience, real estate funds may be involved in construction or redevelopment, and it is common for them to be involved in operations.

ED BC12

An additional concern of the IASB is that an 'internal' investment entity could be misused in a larger corporate structure, say in a manufacturing group, to achieve a particular accounting outcome. The example given in the basis for conclusions is 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 (R&D) activities, in order to avoid consolidating those activities. Such an internal investment entity would not qualify for the exception under the proposals; there are no unrelated investors (see 5.2.2) and the parent is the beneficiary of the results of the subsidiary's operations, in this example the results of R&D.

## 5.1.2 Exit strategies required

ED B9, B11

An investment entity would need a documented potential exit strategy that includes the plan to realise capital appreciation. The identified strategy would depend on the nature and objectives of the investment. The following are examples of exit strategies for debt and equity securities, but the proposals also refer to investments in individual assets such as real estate.

Debt securities	Equity investments
<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>

ED B10

Identifying a *potential* exit strategy is sufficient to meet this criterion.

### Observations – Part of vs the entire investment portfolio

It is not entirely clear in the proposals whether the exit strategy is required for the whole investment portfolio (including non-controlling interests) or for controlled investees only. As the proposals include example exit strategies for individual assets such as real estate and commodities, it appears that the exit strategy should be documented for the whole investment portfolio.

### Observations – Time period for exit

The proposals do not specify a time frame in which an entity should exit an investment. While it appears logical that the exit strategy should be within a reasonable period based on the nature of the investee and assets held, this is not stated. For example, would it ever be reasonable to have an expected exit time of thirty years?

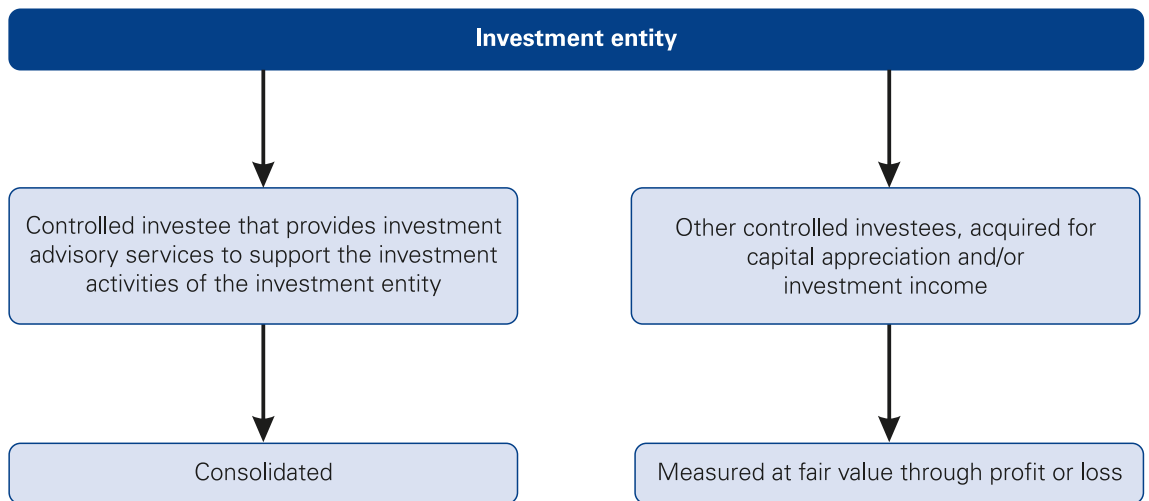
**Observations – Exit strategy in a master-feeder structure**

For master-feeder structures, the typical exit strategy for the feeder fund is the ability to redeem the units held in the master fund. Although it is unclear whether the master fund would need to define the exit strategy for its investments, the proposals illustrate a master-feeder structure and note that the master-feeder fund has documented exit strategies (see example in 7.3). This could be read as requiring an exit strategy at the master fund level.

**5.1.3 Narrow exception for investment advisory services**

ED 7(a), B2

As part of its activities, an investment entity could provide investment advisory services but only if they relate to its own investment activities. If the investment entity has a subsidiary that provides such services, then that subsidiary would be consolidated by the investment entity; however, all other controlled entities would still be measured at fair value.



**Observations – No flexibility in respect of investment advisory services**

The proposals include no flexibility in terms of investment advisory services, which would need to be related *solely* to the investment entity’s activities. At first glance, it appears that *any* level of additional services would impair an entity’s status as an investment entity.

**5.1.4 Exception for collateral held**

ED 7(b), B3

If an investment entity holds collateral temporarily as a result of the default of an investee, then it would retain its status as an investment entity, provided that it had no initial intention of obtaining such collateral. In such cases, collateral would be expected to be disposed of within a reasonable time for similar assets in current market conditions. Assets held as a result of default would be accounted for in accordance with the applicable IFRS.

## 5.1.5 Multiple investments required but can be held indirectly

ED 2(a), B4

An investment entity would need to hold multiple investments at the same time. Such investments could be held directly or indirectly through another investment entity, such as a master fund that is formed for legal, regulatory, tax or other business reasons together with the investment entity (feeder fund).

ED B5

There could be instances in which suitable investments have not yet been identified at inception of the investment entity, or have been disposed of and not yet replaced; or the investment entity might be winding up its operations. In such cases, the investment fund would maintain its status as an investment entity. See 7.2 for an example.

## 5.2 Investors



### 5.2.1 Unit ownership represents identifiable portion of net assets

ED 2(c), B12, B13

Although each unit of ownership would need to represent an identifiable portion of the net assets of the investment entity, it would not need to represent a proportionate interest in all of its underlying investments. For example, an investment entity could have multiple share classes with separate investment pools per share class.

#### Observations – Proportion vs portion

There is some tension between the body of the proposals, which refers to *proportionate* shares of net assets, and the proposed application guidance, which refers to a specifically identifiable *portion* of net assets. Therefore, it is not entirely clear how preferential rights, such as in a waterfall structure, should be interpreted.

#### Observations – Status of investment-linked insurance funds unclear

It is not clear from the proposals whether investment-linked insurance funds would meet the definition of an investment entity. Such funds usually consist of investment and protection components, e.g. life insurance. At first glance, it appears that the presence of a protection component may preclude such funds from qualifying as an investment entity, as any potential returns from this component will not depend on the performance of the fund, but on a specific future event.

### 5.2.2 Significant level of unrelated investors generally required

ED 2(d), B14

In general, an investment entity would need to have multiple unrelated investors who together hold a significant share of ownership. For this purpose all investors related to the parent of the investment fund (if any) would be treated as a single investor.

### Observations – No bright-lines set

The proposals do not provide a quantitative threshold for a minimum number of unrelated investors or a prescribed percentage for their holdings. Accordingly, investment funds would need to apply judgement in determining whether the criterion is met, and perhaps would need to consider their planned marketing strategy and the point of time in their life-cycle (e.g. at inception vs mature).

### Observations – Voting rights

The proposals do not mention the effect of voting rights on the analysis, as different units may be assigned different voting rights, e.g. when different voting rights are assigned to different share classes. For example, it is not clear if a fund could qualify as an investment entity when the related party holds the majority of voting rights, but not the majority of the net assets.

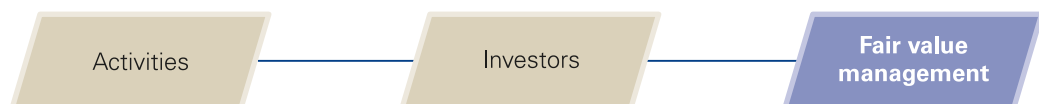
ED B15

If the parent (or a related party) intends to acquire another investor's units in the investment fund, as part of an explicit or implicit arrangement, then these units would be treated as owned by the parent. Such an arrangement could be in the form of an option to acquire the other investor's units, or funding provided by the parent to another investor to purchase the units that serve as collateral for the debt.

ED B16

A single investor would be acceptable when the investment entity is formed together with this investor for specific legal, regulatory, tax or other business reasons. For example, if a master fund is formed with a single investor that is itself an investment entity (i.e. feeder fund that has several unrelated investors), then the master fund would meet the definition of an investment entity, provided that all other criteria are met.

## 5.3 Fair value management



ED 2(e), 2(f), B17

An investment entity would need to manage all of its investments on a fair value basis, and their performance would need to be evaluated and reported to investors on a fair value basis. This includes a requirement that investment property be accounted for at fair value under IAS 40 *Investment Property*, i.e. fair value is not simply disclosed in the notes to the financial statements. The proposals point out that the investment entity needs to demonstrate that fair value is the *primary* measurement attribute used in assessing financial performance.

### Observations – Fair value management encompasses the business as a whole

Managing a controlled investee on a fair value basis means more than simply managing the underlying assets of the investees on a fair value basis, e.g. property; it means the value of the investment as a whole, i.e. a business valuation.

Many geared real estate funds, in particular, manage the underlying assets of the investee (i.e. property) on a fair value basis but manage any debt in the structure on the basis of amortised cost. This would appear to rule out qualification as an investment entity.

### Observations – Accounting vs reporting

The proposals refer to accounting for investment property under the fair value model in order to qualify as an investment entity. However, it is unclear whether the proposals are referring to investment property held by the investment entity itself, i.e. not via a subsidiary, or whether it is requiring the controlled investees of an investment entity to account for investment property under the fair value model.

Additionally, it is not entirely clear whether investment property would be a specific requirement, or whether it is simply an example and all assets and liabilities would need to be measured on a fair value basis to the extent permissible, e.g. property within the scope of IAS 16 *Property, Plant and Equipment*.

These are important points for funds that manage and report on a fair value basis, but which do not necessarily account on a fair value basis within the financial statements. In particular, in our experience while the majority of private equity funds currently account for investments on a fair value basis within the financial statements issued to investors, a minority retain an amortised cost basis of accounting and include separate fair value disclosures in the notes to the financial statements. It appears that this minority of funds would not be able to argue that fair value is the primary measurement attribute used to assess financial performance and therefore would not qualify as investment entities.

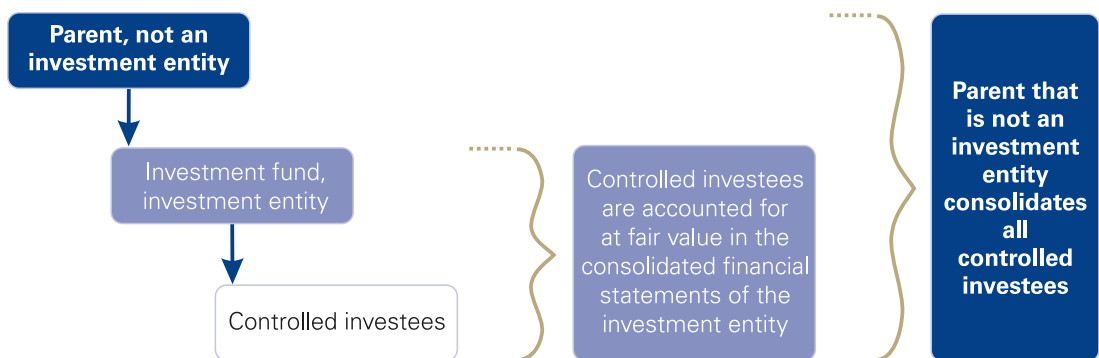
### Observations – Unit of account for controlled investees that are listed

When measuring investments in controlled entities at fair value, it is not clear whether the investee could be valued taking into account a control premium. On the one hand, the unit of account in accordance with these proposals would be the investee as a whole, which implies that a control premium may be appropriate. But on the other hand, IFRS 13 states that when a Level 1 input (i.e. fair values measured using quoted prices (unadjusted) in active markets for identical assets or liabilities) is available for an asset or liability, it is used without adjustment except in specific limited circumstances.

## 6. Exception not carried through to the parent

ED 8, BC19, BC20

The investment entity accounting at fair value through profit or loss would not be retained in the consolidated financial statements of its parent if the parent is not itself an investment entity. The IASB explains that it expects, in most cases, that investment entities will have investment entity parents, which means that the exception would be carried through.



However, in our experience some investment entities will have a parent that is a bank or an insurance company or another non-investment entity. Furthermore, it is realistic to envisage situations in which the investment manager will control the investment fund under IFRS 10, and therefore would be required to consolidate all 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 would still be required, just at a higher level.

### Observations – Potential consolidation by investment managers

The requirements of IFRS 10 may cause a change in the consolidation conclusion for some investment managers in relation to investment funds. As a result, such investment managers would be required to consolidate the investment fund and any other entities controlled by the investment fund. This is an added complexity to bear in mind when responding to the proposals.

We recommend timely consideration of the requirements of IFRS 10 for all entities that are involved in setting up or managing investment funds. For further guidance on IFRS 10 as it applies to investment managers, see our publication *First Impressions: Consolidated Financial Statements*.

### Observations – Potential US GAAP differences

Interestingly, the FASB's Proposed Accounting Standards Update is expected to differ from the IFRS proposals in two key respects.

- The IFRS proposals do not extend to the parent of an investment entity that is not itself an investment entity; the FASB proposals are not expected to be restricted in this way and the consolidation exception is expected to carry through to the parent.
- The IFRS proposals extend to the parent of an investment entity that is also an investment entity; the FASB proposals are expected to require a parent investment entity to consolidate controlled investees that are themselves investment entities.

It is not clear why the Boards are planning to propose GAAP differences, since as late as November 2010 the Boards stated publicly that they expected to achieve convergence in respect of a consolidation exception for investment entities (see section 3).

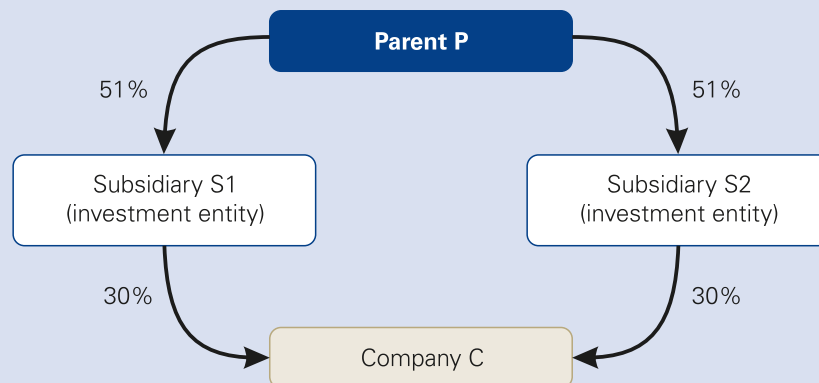
*ED D IAS 28 (2011),  
BC20*

Unlike controlled investees, the measurement exception for associates and joint ventures would be carried through to the parent's (investor's) consolidated financial statements in all cases.

### Observations – Uncertainty over split holdings

The lack of symmetry in the accounting for controlled investees vs associates/joint ventures at the level of a parent (investor) that is not an investment entity is likely to raise interpretative issues.

For example, 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 fair value through profit or loss. At the consolidated level, P controls C through its 51 percent holdings in S1 and S2; the remaining interests are held by parties unrelated to P. Under the proposals, would P consolidate C, or would it carry through the measurement exception used by S1 and S2 and therefore account for its investment in C at fair value through profit or loss?



## 7. Illustrative examples

The proposals include four illustrative examples, three of which are included in summarised form in the examples that follow:

- technology fund (see 7.1)
- private equity fund (see 7.2)
- master-feeder structure (see 7.3)

While the examples are not an integral part of the proposals, they may be helpful in understanding the intention of the IASB. An additional real estate example in the proposals is discussed in 5.1.1; the real estate example in 7.4 is different from the IASB's example.

### 7.1 Technology fund

ED IE2

<p><b>Scenario</b></p>	<p><b>Activities</b></p> <ul style="list-style-type: none"> <li>• High-tech Fund HT was formed by six technology companies to invest in technology start-up companies for capital appreciation.</li> <li>• No exit strategy has been identified by HT.</li> <li>• HT is managed by an unrelated investment advisor.</li> </ul> <p><b>Investors</b></p> <ul style="list-style-type: none"> <li>• Investors in HT (i.e. the six technology companies) hold options to acquire the investments held by HT at fair value, if the technology developed by the investees would benefit the operations of the investors.</li> </ul> <p><b>Fair value management</b></p> <ul style="list-style-type: none"> <li>• No information.</li> </ul>
<p><b>Analysis</b></p>	<p>HT does not qualify as an investment entity.</p> <ul style="list-style-type: none"> <li>• The technology companies hold options to acquire HT's investments if the assets developed by the HT's investees would benefit their operations. This provides an additional purpose other than from capital appreciation and/or investment income (see 5.1.1).</li> <li>• HT has no exit strategy.</li> </ul>
<p><b>Observations</b></p>	<p>The example in the proposals does not discuss the relationship between HT and the six investors for the purpose of understanding the ownership structure of HT (see 5.2.2). However, in practice it would be necessary to consider this factor if it was determined that the business activities were restricted to capital appreciation and/or investment income.</p>

ED IE2

## 7.2 Private equity fund

ED IE1	<b>Scenario</b>	<p><b>Activities</b></p> <ul style="list-style-type: none"> <li>• Limited Partnership PE is formed with a 10-year limited life.</li> <li>• The prospectus outlines that the purpose of PE is to invest in companies with rapid growth potential, with the objective of realising capital appreciation over its life.</li> <li>• PE could not immediately identify suitable investments. The first investment with a controlling interest is acquired after 12 months and five more 18 months after the commencement of operations.</li> <li>• PE plans to sell its interests in investees by the end of year 10; the available alternatives include disposal of the investments or the distribution of equity securities to investors after the public offering.</li> </ul> <p><b>Investors</b></p> <ul style="list-style-type: none"> <li>• Over 70 unrelated limited partners provide 99 percent of the funding.</li> </ul> <p><b>Fair value management</b></p> <ul style="list-style-type: none"> <li>• PE manages its investments and provides financial information to the partners on a fair value basis.</li> </ul>
ED IE1	<b>Analysis</b>	<p>PE qualifies as an investment entity from the date of its formation.</p> <ul style="list-style-type: none"> <li>• PE's only activity is acquiring equity interests for capital appreciation (see 5.1.1).</li> <li>• A potential exit strategy is identified and documented for each investment (see 5.1.2).</li> <li>• Although PE does not hold multiple investments from formation, it is actively pursuing investment opportunities; its intention is to hold multiple investments (see 5.1.5).</li> <li>• The ownership structure is represented by units of partnership interests (see 5.2.1).</li> <li>• PE is funded primarily by unrelated investors who collectively hold a significant ownership interest (see 5.2.2).</li> <li>• The investments are managed on a fair value basis and financial information about PE's activities is provided to investors (see 5.3).</li> </ul>
	<b>Observations</b>	<p>This example is simplistic because it ignores any discussion related to the range of involvement that a private equity fund might have in controlled investees. This is discussed in 5.1.1.</p>

## 7.3 Master-feeder structure

ED IE4

<b>Scenario</b>	<p><b>Activities</b></p> <ul style="list-style-type: none"> <li>• A master fund and two feeder funds (master-feeder structure) are formed together to meet legal, regulatory and tax requirements.</li> <li>• The master fund holds multiple investments for capital appreciation and investment income.</li> <li>• The investment objective of the master-feeder structure is outlined in the prospectus.</li> <li>• The master fund has identified and documented exit strategies for its investments.</li> </ul> <p><b>Investors</b></p> <ul style="list-style-type: none"> <li>• The feeder funds have multiple unrelated investors who hold 99 percent of the overall ownership interests.</li> </ul> <p><b>Fair value management</b></p> <ul style="list-style-type: none"> <li>• Investors receive periodic financial information from the feeder funds on a fair value basis.</li> </ul>
<b>Analysis</b>	<p>Each fund in the master-feeder structure qualifies as an investment entity.</p> <ul style="list-style-type: none"> <li>• The business purpose of the structure was communicated to investors in the prospectus, being investing for capital appreciation and investment income (see 5.1.1).</li> <li>• Potential exit strategies for investments are identified and documented (see 5.1.2).</li> <li>• The master fund holds multiple investments; the feeder funds meet the multiple investments criterion as they were formed in conjunction with the master fund (see 5.1.5).</li> <li>• The ownership is represented by units (see 5.2.1).</li> <li>• The master fund was formed in conjunction with the feeder funds that are funded primarily by multiple unrelated investors (see 5.2.2).</li> <li>• The investments are managed on a fair value basis and information about the activities of the master-feeder structure is provided regularly to investors (see 5.3).</li> </ul>
<b>Observations</b>	<p>Although it is unclear in the proposals whether the master fund would need to define the exit strategy for its investments (see 5.1.2), the above example could be read as requiring it to do so.</p> <p>Additionally, notwithstanding that typically the most common exit strategy for a feeder fund is to redeem the units held in the master fund, this example does not mention an exit strategy for the feeder funds. It is not clear whether redemption is assumed because the feeder funds were formed in conjunction with the master fund.</p>

ED IE4

## 7.4 Real estate fund

<p><b>Scenario</b></p>	<p><b>Activities</b></p> <ul style="list-style-type: none"> <li>• Real estate fund LP invests in Companies A, B and C that each holds one property.</li> <li>• LP invests only in mature, developed properties, for the purpose of capital appreciation and investment income; this was communicated to potential investors in the prospectus.</li> <li>• The day-to-day management (e.g. maintenance) of the properties is delegated to an independent property manager.</li> <li>• Bank B provides additional funding to Companies A, B and C in the form of a loan.</li> <li>• The property in each company is leased out to independent lessees on a 5-year contract basis.</li> <li>• LP has an exit strategy for every property and it intends selling investments on average in 7 years.</li> </ul> <div data-bbox="544 981 1490 1234" style="text-align: center;"> <pre> graph TD     LP[Real estate fund LP] --&gt; CA[Company A]     LP --&gt; CB[Company B]     LP --&gt; CC[Company C]     CA --&gt; PA[Property A]     CB --&gt; PB[Property B]     CC --&gt; PC[Property C]     BB[Bank B] --&gt; CC   </pre> </div> <p><b>Investors</b></p> <ul style="list-style-type: none"> <li>• A significant portion of units in the fund is held by investors unrelated to the fund.</li> </ul> <p><b>Fair value management</b></p> <ul style="list-style-type: none"> <li>• While LP manages the properties of Companies A, B and C on a fair value basis, the debt funding from Bank B is managed on the basis of amortised cost; additionally, information is reported to investors on this mixed measurement basis.</li> </ul>
<p><b>Analysis</b></p>	<p>LP does not qualify as an investment entity because its investments in Companies A, B and C are not managed on a fair value basis (see 5.3).</p>
<p><b>Observations</b></p>	<p>Even if LP were managing and reporting its investments in Companies A, B and C on a fair value basis, it would be necessary to consider LP's role in the operations of Companies A, B and C, which might in any event lead to it failing to qualify as an investment entity. This is discussed in 5.1.1.</p>

## 8. Disclosures expanded

*ED 9* The overall objective of the proposed disclosures is to enable users of the financial statements to evaluate the nature and financial effects of the investment activities of an investment entity.

*ED 10, BC21* As investments in controlled investees of qualifying investment entities would be measured at fair value through profit or loss in accordance with IFRS 9, the relevant disclosure requirements of IFRS 7 and IFRS 13 would apply. Additionally, IFRS 12 would continue to apply.

### Observations – Control assessment still required

An investment entity would measure all controlled investees, associates and joint ventures at fair value (see section 4). However, the disclosure proposals reinforce the fact that an investment entity would not be able to avoid making a control assessment in respect of each investee to ensure that it is categorised properly for disclosure purposes.

### Observations – Feeder fund disclosures

The proposals include no guidance in respect of disclosures in the financial statements of a feeder fund that controls the master fund. Therefore, it is unclear to what extent the financial statements of the feeder fund should reflect the underlying investments of the master fund in order for users to understand the investment activities of the fund.

The proposals introduce the following specific disclosures in respect of the *controlled investees* of an investment entity:

- ED 10(b), (c), BC22*
  - financial or other support provided or intended to be provided to controlled investees, when there is no contractual obligation to do so, including the type, amount and reasons for support; or any assistance to a controlled investee in obtaining financial support;
- ED 10(d), BC23*
  - the nature and extent of any significant restrictions on the ability of the controlled investee to pay dividends, or repay interest or principal in respect of debt. Such restrictions may result, for example, from contractual arrangements or regulatory requirements; and
- ED B18*
  - a list of investments in controlled investees, including the name, country of incorporation or residence, proportion of ownership interest and, if different, the proportion of voting power held. When the investment entity has a controlled investee that is itself an investment entity, these disclosures would apply to both direct and indirect investees. In satisfying this requirement, the investment entity could incorporate the investee's financial statements into its own financial statements.

*ED B19, B20* The proposals also identify the following disclosures that may be necessary in meeting the overall disclosure objective, to the extent not already disclosed under other standards.

### PER-SHARE INFORMATION:

- total assets less total liabilities on a fair value basis at the beginning of the period;
- net investment income or loss;
- realised and unrealised gains and losses, calculated as the balancing amount necessary to reconcile the change in fair value per share with the other per-share information presented;

**PER-SHARE INFORMATION:**

- total income from investment operations;
- distributions to shareholders;
- purchase premiums, redemption fees or other capital items;
- payments by affiliates to reimburse losses that violated the investment fund's investment restrictions; and
- total assets less total liabilities on a fair value basis at the end of the period.

**OTHER INFORMATION:**

- ratios of expenses and net investment income to average net assets, including the methodology of computing;
- total return, including the methodology for computing;
- commitments from owners, and the ratio of total contributed funds to total committed funds; and
- the year of formation.

**Observations – Potential information overload**

The proposals refer to the investment entity incorporating the controlled investee's financial statements into its own financial statements in order to satisfy certain disclosure requirements. However, it is not clear whether such an approach always would result in clear information and meet the overall disclosure objective of the proposals.

## 9. Changes in status accounted for prospectively

*ED 3* If facts and circumstances indicate that there is a change in an entity's status as an investment entity, then the investment fund reassesses whether it still qualifies as an investment entity.

### 9.1 Qualifying for the first time

*ED 5* When an investment fund qualifies as an investment entity for the first time (other than upon adoption of the final amendment; see section 10), it would account for the change prospectively. An adjustment to opening retained earnings would be recognised in other comprehensive income in its consolidated financial statements as the difference between (1) the carrying amount of the net assets of the entity's investees; and (2) the fair value of those investees at the date of the change in status, plus any changes in the fair value of investees' net assets recognised previously and remaining in accumulated other comprehensive income.

*ED 5, 10(a)* The investment fund would disclose the change in status and the reasons for the change, as well as the effect of applying the exception from the date of the change in status.

Subject to the observations below, the following example illustrates the proposals.

#### Example – Qualifying as an investment entity

Investment Fund IF has consolidated Subsidiary S since its incorporation a number of years ago; IF has a 60 percent holding in S. On 1 June 2015, after the final 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.
- The carrying amount of non-controlling interests (NCI) in equity is 400.
- The fair value of IF's 60 percent 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.

Subject to the observations noted below, it appears that IF would record the following entry at 1 June 2015.

	<i>Debit</i>	<i>Credit</i>
Investment in S	1,500	
NCI	400	
Other comprehensive income (revaluation reserve)	150	
Other comprehensive income (retained earnings)		1,050
Various assets and liabilities		1,000
<i>To deconsolidate S upon qualifying as an investment entity</i>		

### Observations – Date of calculating effect of change in status

The proposals refer to the effect of any change in status being determined at the date of the actual change. However, the proposals also refer to the effect of the change being recognised in opening retained earnings at the start of the period in which the change occurs. This might imply that the effect should be determined at the start of the period. This will need to be clarified in the final amendments.

### Observations – Accumulated other comprehensive income

The proposals refer to *accumulated* other comprehensive income, which is not a term defined in IFRSs, although IAS 1 *Presentation of Financial Statements* refers to the accumulated balance of each class of other comprehensive income within equity. Therefore, it appears that the proposals are referring to *all* changes in the fair value of investees' net assets recognised previously and remaining in equity, e.g. revaluations of property, plant and equipment. On this basis, the amount calculated in part (2) of the above formula for purposes of the example is 1,050 (900 + 150) after adjusting for NCI.

However, in order to ensure that the amount recognised in other comprehensive income is not double counted (i.e. the 150 credited twice over the years), the transfer of 150 out of the revaluation reserve is debited to other comprehensive income. Accordingly, a net amount of 900 is recognised in other comprehensive income.

This issue will need to be clarified in the final amendments.

## 9.2 Ceasing to qualify

ED 4

When an investment fund ceases to qualify as an investment entity, IFRS 3 *Business Combinations* is applied at that date in its consolidated financial statements. The fair value of controlled investees at the date of the change becomes their carrying amount at that date, i.e. the consideration transferred in applying IFRS 3.

ED 10(a)

The investment fund would disclose the change in status and the reasons for the change.

### Observations – Scope of IFRS 3

Although not stated in the proposals, it appears that IFRS 3 would apply only to controlled investees that are within the scope of that standard, i.e. businesses. The proposals are silent on controlled investees that are not businesses, but presumably other relevant IFRSs would apply, e.g. IAS 40 for investment property. Again, this will need to be clarified in the final amendments.

## 10. Effective date expected to be aligned with IFRS 10

ED C1, C3

No effective date is specified in the exposure draft, but we expect it to be aligned with IFRS 10, i.e. annual periods beginning on or after 1 January 2013. If an entity applies the final amendments prior to the effective date, then it would be required to adopt the following at the same time: IFRS 10, IFRS 11, IFRS 12 and IAS 28 (2011). In addition, IAS 39 *Financial Instruments: Recognition and Measurement* would apply if IFRS 9 has not yet been adopted.

ED C2

The effect of applying the amendments at the date of adoption would be recognised as an adjustment to consolidated retained earnings at the beginning of that period, i.e. comparatives would not be restated. An adjustment to opening retained earnings would be recognised as the difference between (1) the carrying amount of the net assets of the entity's investees; and (2) the fair value of those investees at the date of first applying the amendments, plus any changes in the fair value of investees' net assets recognised previously and remaining in accumulated other comprehensive income.

### Observations – Similar to adjustment upon qualifying for the first time

The above calculation of the adjustment to retained earnings is the same as the calculation illustrated in 9.1 in respect of a fund qualifying as an investment entity for the first time. However, the following appear to be key differences.

- The adjustment on transition is calculated at the *beginning* of the period in which the standard is adopted.
- The transitional adjustment is not recognised in other comprehensive income, although the position is not clear for any amounts to be removed from accumulated other comprehensive income (150 in the example in 9.1). This will need to be clarified in the final amendments.

# 11. Not all Board members agree

AV1–AV11

Three Board members voted against the proposals. All three believe that consolidating controlled investees provides more relevant and more representationally faithful financial information. They note that better comparability is achieved through consolidation because the investment entity has the power to control the activities of such investees. They point out that additional fair value information could be provided in the notes to the financial statements or in separate financial statements in which investments in controlled investees are measured at fair value through profit or loss. Lastly, they believe that the definition will come under significant interpretive pressure and will result in the Board and the IFRS Interpretations Committee being asked to develop application guidance.

AV12–AV14

One of these Board members notes two further objections. He believes that if the Board proceeds with the amendment, then:

- an investment entity with a parent that is not an investment entity should not be required to account for its investments in controlled entities at fair value through profit or loss; and
- investment entities should be allowed an accounting policy choice of cost or fair value through profit or loss in accounting for controlled investees.

## Observations – Key for IFRS investment funds to comment

It appears that the best constituents to judge these alternative views are those investment funds already consolidating controlled investees under IFRSs or IFRS equivalents (such as IFRS in the European Union, Australia and Hong Kong) and providing the consolidated financial information to investors as their primary financial information about the fund. These constituents are likely to have the best insight into the cost vs benefit of preparing such consolidated financial information.

## About this publication

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

### Content

Our *New on the Horizon* publications are prepared upon the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of *New on the Horizon* considers the proposals in ED/2011/4 *Investment Entities*, which was published by the IASB on 25 August 2011.

The text of this publication is referenced to the exposure draft by way of references in the left-hand margin.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this exposure draft in light of the entity's own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

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