

## IFRS in Focus

# IASB issues exposure draft on investment entities

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### The Bottom Line

- The exposure draft proposes that an investment entity be required to measure investments in entities it controls at fair value through profit or loss rather than consolidating those entities.
- Strict criteria would have to be met for an entity to be considered an investment entity.
- A parent of an investment entity would consolidate all entities it controls, including those controlled through an investment entity, unless the parent itself is an investment entity.
- The proposals would be applied prospectively, with the effect of adoption recognised through an adjustment to retained earnings.
- Comments on the proposals are due by 5 January 2012.

On 25 August 2011, the International Accounting Standards Board (IASB) published ED/2011/4 *Investment Entities* (the 'ED'). The ED would require an investment entity to recognise entities it controls at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement* if IFRS 9 is not yet being applied). Therefore, investment entities would no longer apply consolidation accounting guidance to their controlled investments. However, a parent of an investment entity would consolidate all entities it controls (including those held through an investment entity) unless the parent is also an investment entity. The parent of an investment entity would not be permitted to retain the fair value accounting applied by the investment entity.

### Definition of an investment entity

For an entity to be considered an investment entity, it would need to meet all of the following criteria:

- the entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both;
- the entity makes an explicit commitment to its investors that the purpose of the entity is investing to earn capital appreciation, investment income (such as dividends or interest), or both;
- ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed;
- the funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors who are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity;

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[www.iasplus.com](http://www.iasplus.com)

[www.deloitte.com](http://www.deloitte.com)

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## An investment entity must have no other substantive activities, assets or liabilities other than those relating to investing activities.

- substantially all of the investments of the entity are managed, and their performance evaluated, on a fair value basis; and
- 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.

### Nature of the investment activity

An investment entity must have no other substantive activities, assets or liabilities other than those relating to investing activities. However, an investment entity may provide investment advisory services related to its own investment activities and may temporarily hold defaulted collateral from collateralised investments (e.g., real estate securing commercial mortgage loans) so long as the entity did not acquire the investments with the intention of controlling the secured collateral. In assessing whether collateral is being held temporarily, an entity would consider:

- their general policies and past practices regarding holding collateral and the associated risk exposures;
- their strategies for disposing of the collateral including the expected time frame for disposal;
- the time necessary to sell similar assets under current market conditions; and
- any rights that third parties may have over the collateral.

Although the business purpose of an investment entity would be the holding of multiple investments, either directly or indirectly, it is not required to hold multiple investments at all points in time. For example, an investment entity could hold cash rather than multiple investments during its initial offering period, during the process of liquidation or while identifying suitable investments (either initial investments or redeploying capital following investment disposals).

### Observation

An investment entity may hold multiple investments indirectly through another investment entity such as isolating an investment into a separate legal structure for regulatory, tax, legal or other business reasons. For example, an entity may hold an indirect investment through a master-feeder structure where investors invest in an on-shore or an off-shore feeder fund (dependent on their domicile) which in turn invests in a master fund that holds multiple investments. While the only investment of each feeder fund is its interest in the master fund, the feeder fund would be considered to hold multiple investments through its interest in the master fund.

The guidance supporting the investment activity criterion includes various examples of activities that would demonstrate an entity is not investing for capital appreciation, investment income (such as dividends or interest), or both:

- acquiring, using, exchanging or exploiting the investee's (or its affiliates) processes, intangible assets or technology;
- joint arrangements or other arrangements between the entity (or its affiliates) and the investee (or its affiliates) to develop, produce, market or provide products or services;
- the entity (or its affiliates) and the investee (or its affiliates) entering into transactions:
  - on terms unavailable to non-related parties;
  - at off-market prices; or
  - that represent a significant portion of the business activity of the entity, and its affiliates, and the investee, and its affiliates;
- the entity (or its affiliates) holding disproportionate or exclusive rights to purchase or otherwise acquire the investee's (or its affiliates) assets, technology, products, or services;
- the investee (or its affiliates) providing financial guarantees or collateral for the entity's (or its affiliates) borrowing arrangements; and
- an affiliate of the entity holding a purchase option over the entity's ownership interest in the investee.

An investment entity ... is explicitly committed to investors for the sole purpose of investing for returns from capital appreciation, investment income (such as dividends or interest) or both.

#### **Observation**

These examples illustrate the Board's intention for the proposals in the ED to apply only in a narrowly defined set of circumstances and to ensure that entities acquired for wider business purposes continue to be consolidated.

#### **Business purpose**

An investment entity as defined in the ED is explicitly committed to investors for the sole purpose of investing for returns from capital appreciation, investment income (such as dividends or interest) or both. Offering memorandums, prospectuses, indenture agreements, marketing materials, and partnership agreements may provide evidence of the investment objective of the entity, as may the manner in which it presents itself to prospective investors.

As part of the express business purpose, an investment entity should identify and document the potential exit strategies for realising capital appreciation or receiving distributions or interest from its investments. Exit strategies will vary based on the type of specific investments held by the entity. Hedge funds and mutual funds holding public equity securities would be likely to have an exit strategy of disposal through an exchange, while private equity funds would be more likely to have exit strategies such as initial public offerings or private placement of equity securities. Exit strategies for debt securities could include broker assisted private placements or conversion of convertible debt to equity securities and disposing of those equity securities through public markets.

#### **Unit ownership**

An investment entity is owned by investors through ownership units (e.g., ordinary shares or partnership interests) which represent a specifically identifiable portion of the net assets of the entity. However, the ownership unit does not have to represent a proportionate interest in all of the investments of the investment entity. An investment entity can have multiple classes of equity investments.

#### **Observation**

Investment structures such as collateralised debt obligations and other asset-backed securitisations will not be likely to meet this criterion as they represent subordinated interests in cash flows from a pool of assets rather than a proportionate share in the net assets of the entity.

#### **Pooling of funds**

An investment entity sells ownership interests to investors in order to pool the raised capital to achieve its investment objectives. Investors unrelated to the investment entity's parent (if any) must hold significant ownership interests in the entity, which the parent (or its related parties) do not have an implicit or explicit arrangement to acquire. However, the ED does permit an entity whose single investor is an investment entity, to still be considered an investment entity if it meets all of the other investment entity criteria.

#### **Observation**

The exception to the pooling of funds criteria when a single investor entity is also an investment entity may help to address certain investment fund structures. For example, a master-feeder structure under which investors invest in a feeder fund based on domicile or currency and the feeder fund in turn invests in a master fund which deploys the capital to strategic investments. The master fund's only investors would be related parties and therefore would not otherwise meet the pooling of funds criteria.

#### **Fair value management**

An investment entity manages, evaluates and reports its investment performance internally and externally on a fair value basis. To meet this criterion, information provided to management of the entity for decision making purposes and information provided to investors must be prepared on a fair value basis.

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## Parents of investment entities would continue to be required to consolidate all entities that they control, including those controlled through an investment entity.

### Parents of investment entities

The ED does not propose that the exception to consolidation be extended to parents of investment entities (unless they themselves are investment entities). Parents of investment entities would continue to be required to consolidate all entities that they control, including those controlled through an investment entity.

The Board considered whether the use of fair value rather than consolidation should be extended to a non-investment entity parent of an investment entity, but have proposed that it should not be for the following reasons:

- the Board expects that in most cases investment entities will have investment entity parents, meaning that fair value accounting will be available when needed; and
- the Board had concerns over potential accounting inconsistencies and possibilities for abuse (for example, the issue of the parent's equity to an investee of its investment entity subsidiary in order to increase the fair value of that investee and thus artificially increase the parent's consolidated net assets).

### Disclosures

The ED proposes specific disclosure requirements for investment entities in addition to those required by IFRS 7 *Financial Instruments: Disclosures* and IFRS 12 *Disclosures of Interests in Other Entities* including:

- if the status as an investment entity has changed, information on both the reason for the change and the impact on the financial statements;
- if the investment entity has provided any financial or other support to controlled entities during the financial statement period when it was not contractually required to do so, information on the type and amount of support provided and the reasons for providing the support;
- any current intention to provide financial or other support to a controlled investee (including assisting in obtaining financing); and
- the nature and extent of any significant restrictions on an investee's ability to transfer funds to the investment entity (whether cash dividends or repayments of loans or advances).

For controlled investments, the proposed disclosure requirements include the investee's name, country of incorporation or residence and the proportionate ownership interest in the investee held (and if different, also the proportion of voting interest held). For investment entities which control another investment entity, the disclosure requirements would also apply to that controlled investment entity.

The ED also proposes additional disclosures including:

- detailed per-share information for each period presented;
- ratios of expenses and net investment income to average net assets (including the methodology for computing the ratios);
- total return (including the methodology for computing total return); and
- total committed unfunded amounts from investors, the year of formation and the ratio of total contributed funds to total committed funds of the owners.

### Effective date and transition

The ED does not propose an effective date, although certain Board members have stated they would like to finalise the proposals in time to implement an effective date of 1 January 2013 to coincide with the effective date for IFRS 10, IFRS 11, IFRS 12 and the revisions to IAS 27 and IAS 28.

Early application would be permitted so long as the aforementioned standards have also been applied. Entities meeting the definition of an investment entity would apply the provisions in the ED prospectively by recognising the difference between the previous carrying amounts of the investee's net assets and the investee's fair value as of the date of first applying the provisions in the ED as an adjustment to retained earnings as of the beginning of the period for which the provisions are applied for the first time.

The comment period on the ED will close on 5 January 2012.

## Appendix: Illustrative examples

The following examples of the application of the criteria for an entity to be considered an investment entity have been reproduced from ED/2011/04.

### Example 1

An entity, Limited Partnership, is formed in 20X1 as a limited partnership with a 10-year life. The offering memorandum provides that Limited Partnership's purpose is to invest in entities with rapid growth potential, with the objective of realising capital appreciation over its life. Entity GP (the general partner of Limited Partnership) provides 1 per cent of the capital to the Limited Partnership and has the responsibility of identifying suitable investments for the partnership. Approximately 75 limited partners, who are unrelated to each other, provide the remaining 99 per cent of the capital to the partnership.

Limited Partnership begins its investment activities in 20X1. However, no suitable investments are identified by the end of 20X1. In 20X2 Limited Partnership acquires a controlling interest in one entity, ABC Corporation. Limited Partnership is unable to close another investment transaction until 20X3, at which time it acquires equity interests in five additional operating companies. Other than acquiring these equity interests, Limited Partnership conducts no other activities. Limited Partnership manages its investments on a fair value basis and information about its investments is provided to Entity GP and the external investors on a fair value basis.

Limited Partnership has plans to dispose of its interests in each of its investees during the 10-year stated life of the partnership. Such disposals include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities and the disposal of investments to the public or other unrelated entities.

### Conclusion

Limited Partnership meets the definition of an investment entity from formation in 20X1 to 31 December 20X3. The following conditions exist:

- (a) Although Limited Partnership does not hold multiple investments until 20X3, during each of 20X1, 20X2 and 20X3 its express business plan is to hold multiple investments and it is actively pursuing investment opportunities during these periods.
- (b) Limited Partnership's only activity is acquiring equity interests in operating companies with the purpose of realising capital appreciation over the life of the investments. Limited Partnership has identified and documented an exit strategy for each investment.
- (c) Ownership in Limited Partnership is represented by units of partnership interests acquired through a capital contribution.
- (d) Limited Partnership is funded primarily by investors that are unrelated to each other and collectively hold 100 per cent of Limited Partnership. In addition, no party holds a controlling financial interest.
- (e) The investments are managed on a fair value basis.
- (f) Limited Partnership reports financial information about its activities to its investors.

### Example 2

High Technology Fund was formed by six technology companies to invest in technology start-up companies for capital appreciation. In some circumstances, investors in High Technology Fund hold options to acquire investments held by High Technology Fund, at their fair value, if the technology developed by the investees would benefit the operations of the investors. No plans for exiting the investments have been identified by High Technology Fund. High Technology Fund is managed by an investment adviser that is otherwise not related to the investors.

### Conclusion

Even though High Technology Fund's business purpose and investment activities are investing for capital appreciation and pooling of funds exists, High Technology Fund is not an investment entity because of the following arrangements and circumstances:

- (a) The investors of High Technology Fund hold options to acquire investments in investees held by High Technology Fund if the assets developed by the investees would benefit the operations of the investors. This provides a benefit in addition to capital appreciation, investment income (such as dividends and interest), or both.
- (b) The investment plans of High Technology Fund do not include exit strategies for its investments. The call rights held by investors are not controlled by High Technology Fund and do not constitute an exit strategy.

### Example 3

Real Estate Partnership, a limited partnership with a 25-year life, was formed to own and operate retail properties. The general partner, Retail Property Company GP, initially has a 52 per cent interest in Real Estate Partnership. The limited partners include a number of unrelated investors, both individuals and companies. The limited partners do not have the right to replace or remove the general partner, except for cause (for example, fraud).

Retail Property Company GP has a controlling interest in Real Estate Partnership and is therefore an affiliate of Real Estate Partnership. Real Estate Partnership acquires land for development through contributions of properties from the general partner, Retail Property Company GP.

Retail Property Company GP's interest in Real Estate Partnership is increased on the basis of the value of the contributed properties. The properties are developed into retail centres through development agreements with Retail Property Company GP. After development, the properties are managed by Retail Property Company GP. Retail Property Company GP also develops, owns and operates other retail properties. Upon termination of Real Estate Partnership, the properties may be sold to third parties or Retail Property Company GP may acquire properties from Real Estate Partnership at values determined by independent appraisals.

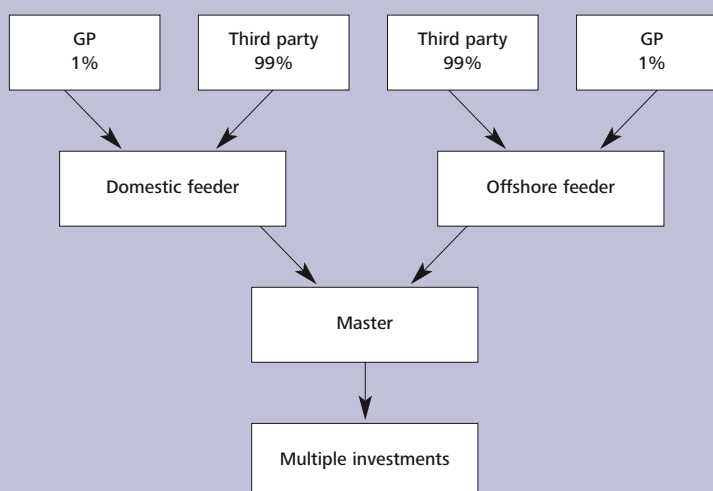
### Conclusion

Real Estate Partnership does not meet the definition of an investment entity because of the following conditions:

- (a) The business purpose and activities of Real Estate Partnership includes developing retail properties. The nature of the partnership's activities would be considered to be other than investing for capital appreciation, investment income (dividends and interest), or both.
- (b) Retail Property Company GP obtains earnings from the properties held by Real Estate Partnership that are other than capital appreciation, investment income (such as dividends and interest), or both, because Retail Property Company GP is actively involved in the development and operation of the properties. Even though these transactions may be on terms that are available to entities that are not related parties of the investee (at a price at which an orderly transaction would take place between market participants at the measurement date), the development and operations of the properties represent a significant portion of the investee's business activities.

#### Example 4

An entity, Master Fund, is formed in 20X1 with a 10-year life. The equity of Master Fund is held by two affiliated feeder funds. The feeder funds are established to meet legal, regulatory, tax or other requirements. The feeder funds are capitalised with a 1 per cent investment from the general partner and 99 per cent from unaffiliated investors (with no party holding a controlling financial interest).



The purpose of Master Fund is to hold multiple investments in order to generate capital appreciation and income (such as dividends or interest). The investment objective communicated to investors is that the role of the Master-Feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Master Fund has identified and documented exit strategies for the investments that it holds. In addition, investors receive periodic financial information, on a fair value basis, from the Feeder funds.

#### Conclusion

Master Fund and the Feeder funds each meets the definition of an investment entity. The following conditions exist:

- (a) The Master-Feeder structure's activities comprise holding multiple investments for returns from capital appreciation and income (such as dividends or interest). Even though the sole investment held by the Feeder funds is their investment in Master Fund, the Feeder funds meet the multiple investments criteria because they were formed in conjunction with another investment entity, Master Fund, which holds multiple investments.
- (b) The Master-Feeder structure's business purpose, which was communicated directly to investors of the feeder funds, is investing for capital appreciation and income (such as dividends or interest). The Master-Feeder Structure has identified and documented potential exit strategies for its investments.
- (c) Ownership in Master Fund and the Feeder funds is represented by units of equity.
- (d) Even though Master Fund is wholly capitalised by the Feeder funds, it was formed in conjunction with the Feeder funds, which are funded primarily by investors who are unrelated to each other. In addition, no party holds a controlling financial interest in the Feeder funds.
- (e) The investments are managed on a fair value basis and information about the investments made by Master Fund is provided to investors on a fair value basis through the Feeder funds.
- (f) Master Fund and the Feeder funds are entities reporting financial information about their activities to their investors.

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