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IFRS in Focus
Fair value rules – new requirements for investment entities

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The Bottom Line

- Where an entity qualifies as an 'investment entity' it does not consolidate its subsidiaries but measures its investments at fair value.
- Consideration of the criteria for meeting the definition of an 'investment entity' will require a degree of judgement based on facts and circumstances.
- These changes may impact entities beyond those traditionally seen as investment-type entities.
- The new requirements for investment entities are effected through a series of changes to IFRS 10 *Consolidated Financial Statements*, IFRS 12 *Disclosure of Interests in Other Entities* and IAS 27 *Separate Financial Statements*.
- The requirements are to be applied retrospectively for reporting periods beginning on or after 1 January 2014.

Background

The International Accounting Standards Board (IASB) has been considering, as part of its Consolidation project, whether entities that measure and manage their investments on a fair value basis (generically known as 'investment entities') should be given relief from the consolidation requirements of IFRS 10 *Consolidated Financial Statements*. The justification for granting such relief has been that for certain entities information on the fair value of their investment in a subsidiary is more relevant than consolidation of its individual assets and liabilities – the difficulty has been to circumscribe those specific 'investment entities' where this is the case. Following comments received on its Exposure Draft (ED), the IASB issued a series of amendments to IFRSs to give effect to new requirements for investment entities. The requirements include some notable differences from those proposed in the ED, particularly to the definition of an 'investment entity' and its application. Under the new requirements, ownership interests in entities controlled by investment entities are to be accounted for at fair value through profit and loss (FVTPL) in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*) rather than being consolidated.

For more information please see the following websites:

www.iasplus.com

www.deloitte.com

The general model

Overview

The new requirements in IFRS 10 are principally concerned with establishing whether an entity qualifies as an 'investment entity'. IFRS 10 emphasises that the definition does not set a 'bright-line' but establishes the typical features of an entity that meets the notion of an 'investment entity'. Accordingly, in applying the definition judgement will need to be exercised.

Where an entity qualifies as an 'investment entity', it is required not to consolidate a subsidiary in accordance with the consolidation provisions of IFRS 10 but instead to measure its investment in the investee at FVTPL (in accordance with IFRS 9 or, when that standard has not yet been adopted, IAS 39). The rationale for this exception to the principle of consolidation of controlled investees is that to consolidate entities that are controlled by an investment entity may reduce the comparability of different investments reported in an investment entity's financial statements and that the fair value of the investment of the investee with changes in that value recognised in profit or loss provides more relevant information for users of the financial statements of investment companies.

Defining an 'investment entity'

The exception to consolidation is based on the type of entity that owns the subsidiary. To qualify as an 'investment entity' an entity is required to:

- Obtain funds from one or more investors for the purpose of providing them with professional investment management services.

- Commit to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both.

- Measure and evaluate performance of substantially all of its investments on a fair value basis.

An entity that meets the definition is expected to have the following 'characteristics':

- Multiple investments.

- Multiple investors.

- Investors that are not related to the parent entity or the investment manager.

- Ownership interests in the form of equity or partnership interests.

The IASB notes that "if an entity does not display one of more of the typical characteristics, it indicates additional judgement is required in determining whether the entity meets the definition of an investment entity" (IFRS 10.BC 233), but this does not necessarily mean that the definition is not met.

In satisfying the business purpose aspect of the definition, the notion of an investment time frame is critical. The investment entity should not hold its investments indefinitely but should have some exit strategy for their realisation. Exit strategies need not be documented for each investment but an entity will have to "identify different potential strategies for different types or portfolios of investments, including a substantive time frame for exiting the investments" (IFRS 10.B85F). Holding debt securities (other than those that have the potential to be held indefinitely) to maturity can be considered an exit strategy.

The existence of benefits other than capital appreciation and/or investment income may indicate that the business purpose aspect of the definition is not met. Such benefits include:

- The acquisition, use, exchange or exploitation of the processes, assets or technology of an investee.

- Joint arrangements or other agreements between the entity or another group member and an investee.

- Financial guarantees or assets provided by investee to serve as collateral for borrowing arrangements of the entity.

- An option held by a related party of the entity to purchase an ownership interest in an investee of the entity.

- Transactions between the entity or another group member and an investee that are not on normal market terms or represent a substantial portion of the investee's or the entity's business activity.

The fair value aspect of the definition requires that investments are measured and evaluated on a fair value basis. That is, the entity provides investors with fair value information and its key management personnel use fair value information as the primary basis for evaluating the performance of substantially all of its investments. An entity is required to account for any investment property, investments in associates and joint ventures and financial assets using the fair value model set out in IAS 40 *Investment Property*, IAS 28 *Investments in Assocates and Joint Ventures* and IFRS 9 respectively but is not required to measure and manage its financial liabilities on a fair value basis.

Investments in associates and joint ventures

The consequential amendments to other standards do not include the changes to IAS 28 *Investments in Associates and Joint Ventures* which were proposed in the exposure draft. The 'investment entity' provisions are achieved by electing to measure such investments at fair value under IAS 28.18 where the investment is held by an entity that is venture capital organisation, mutual fund, unit trust and similar entities including investment-linked insurance funds.

Observation

Failure to make an election to fair value investments in associates and joint ventures results in the exception to consolidation under IFRS 10 not being available to the investment entity group.

Non-investment entities

Non-investment entities are not provided with relief from consolidation and the general requirements of IFRS 10 apply even if they have subsidiaries that are themselves investment entities. This means that a non-investment entity parent company will consolidate all of its subsidiaries, including those controlled via a subsidiary that is an investment entity.

Observation

In a banking group where there may be a number of subsidiaries that qualify as 'investment entities'. However, as the parent itself is unlikely to qualify as an investment entity, their investment entity status will not be extended to the banking group which will need to consolidate all of its subsidiaries.

It should be noted that under IFRS 8 *Operating Segments* if the basis of reporting to the chief operating decision maker is to account for investment entities at FVTPL, that reporting could be maintained for the purposes of the segment reporting note.

The standard also allows for entities that have a business model that encompasses subsidiaries providing investment-related services – even if these constitute a substantive part of their activities. Where this is the case, the servicing subsidiary itself is required to be consolidated but other subsidiaries are still measured at fair value.

Observation

Where an investment entity group includes a subsidiary that provides only services, it does not 'taint' the investment entity treatment for the group it just means that the entity itself would be consolidated as the exception to consolidation is not available for that entity alone.

Disclosures (Amendments to IFRS 12)

Disclosure requirements for investment entities are set out in IFRS 12 *Disclosure of Interests in Other Entities.* An investment entity is required to disclose information about significant judgements and assumptions in determining that it has met the definition of an investment entity. In particular: (a) that it is an investment entity and as such has not consolidated controlled investees; and (b) how it has met the definition and typical characteristics to be an investment entity, with specific reasons given if it has not met one or more of them. An entity beginning or ceasing to be considered an investment entity triggers disclosure with information required on both the reason for the change and the impact on the financial statements.

An investment entity is required to provide details about each unconsolidated subsidiary including any significant restrictions on it to transfer funds to the investment entity; any support the investment entity (or its subsidiaries) has provided an unconsolidated entity without having a contractual obligation to do so. Disclosures are also required for any structured entity that it controls.

Transition and effective date

The investment entity requirements are to be applied retrospectively and are effective for reporting periods beginning on or after 1 January 2014, although early application is permitted.

Convergence with US GAAP

The IASB and FASB had a joint project on 'investment entities' and whilst there were joint deliberations on the development of proposals, the FASB decided not to provide guidance on the measurement of such interests and instead decided to allow investment companies to continue with current industry practice.

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