CONSOLIDATION RELIEF FOR INVESTMENT ENTITIES

AMENDMENTS TO IFRS 10
INVESTMENT ENTITIES AMENDMENTS: WHAT, WHY, WHEN?

• What
  • Exemption from consolidation of investments in controlled entities (operating enterprises or funds) if you qualify as an investment entity
  • Funds will look at these amendments only if they have controlled investees
  • Consolidation exemption is mandatory not optional
  • Investments generally will be at fair value through P&L (FVTPL) with many new disclosures required
  • Some interpretation and application issues are already emerging in practice
  • Some differences from Accounting Guideline 18 (AcG-18)

• Why
  • Considerable industry backlash to potential consolidation of investees
    – Mutual, hedge funds, master-feeder structures, private equity funds expected to qualify; real estate funds less likely to qualify

• When
  • Annual periods beginning on or after January 1, 2014, but early adoption permitted
Prior to amendments, venture capital organizations, mutual funds and similar entities had no exemption from consolidating controlled investees.

- Such entities could elect under IAS 31 and IAS 28 to account for investments in joint ventures and associates at FVTPL.

Amendments to IFRS 10 grant a consolidation exception for investment entities and parents of investments entities that are themselves investment entities.

- Exemption does not flow through to non-investment entity parents.
- IFRS 10 requires certain subsidiaries that are providing investment-related services to be consolidated.
A TWO-STAGE APPROACH

Stage One

Must meet all three essential elements of definition

1. Investment management services
2. Returns from capital appreciation and/or investment income
3. Measure and evaluate performance on a fair value basis

Stage Two

Must consider typical characteristics

- More than one investment
- More than one investor
- Investors not related parties of the entity
- Ownership interests are equity or similar interests
MUST MEET ESSENTIAL ELEMENTS

1. Investment management
   - Obtain funds from investors
   - Investment management services

&

2. Returns from capital appreciation / invest income
   - Commitment to investors
   - Potential exit strategy
   - Some services / benefits restricted

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3. Performance on a fair value basis
   - Primary driver for management
   - Investments accounted for at FV
   - OCI recognition permitted

OCI = other comprehensive income
INVESTMENT-RELATED SERVICES RESTRICTED

Permitted examples

- Investment management services
- Investment advisory services
- Investment support and administration

Prohibited

- Management services / strategic advice to investee
- Financial support to investee
- Unless:
  - Not substantial; and
  - To maximise return

If services provided through a subsidiary

- Consolidate that subsidiary
- Other controlled investees at FVTPL
CONSIDER TYPICAL CHARACTERISTICS

Ownership interests are equity or similar interests

More than one investment

Investors who are not related parties

More than one investor

Absence does not preclude investment entity status: Judgement required
IFRS – INVESTMENT ENTITIES: DECISION TREE

Stage One

Are all of the essential features of the definition met?

- Investment management services (see 4.1)
- Returns from capital appreciation and/or investment income (see 4.2)
- Measure and evaluate performance on a fair value basis (see 4.3)

Are all of the typical characteristics present?

- More than one investment
- More than one investor
- Investors are not related parties of the entity
- Ownership interests in the form of equity or similar interests (See section 5)

Does management believe that the entity is an investment entity?

- Yes
- No

Entity is not an investment entity, and controlled investees consolidated

Yes

Disclosures about management’s judgement required

Entity is an investment entity, and controlled investees accounted for at FVTPL
PARENTS OF INVESTMENT ENTITIES

**Parent is investment entity**
- Must account at FVTPL - mandatory
- Potential dilemma for master-feeder structures

**Parent not investment entity**
- Must consolidate
- Banks, insurers expected among non-investment entity parents
- But also some fund managers
- Associates and joint ventures can be accounted for at FVTPL – policy choice

Significant US GAAP difference
### Significant judgements / assumptions
- Judgements and assumptions to meet classification.
- Further explanation when one or more typical characteristics not present.

### Restrictions / commitments
- Commitment / intention to provide financial support.
- Financial or other support provided without a contractual obligation, with reasons.

### Nature of risks with structured entities
- Contractual arrangements to provide financial support.
- Financial or other support provided without a contractual obligation, with reasons.

**IFRS 7, IAS 24 disclosures apply**
Issues Arising in Practice for Investment Entities
A number of interpretation / application issues are arising in practice in respect of the Investment Entities amendments. Based on wording in the standard, some views are difficult to rule out. Diversity in practice may emerge – no clear conclusions have been reached at this point; some matters are being referred to IFRIC.

- What is the unit of account in determining of the FV of the investments?
- Blocker entities – are they providing investment related services (IRS) and therefore consolidated under IFRS 10.B85E?
- Is one required under IFRS 10.B85E to consolidate subsidiaries providing IRS, when the sub itself is an investment entity?
- Can IFRS 10.B85H be applied when a parent buys an investment entity subsidiary after its formation?
An investment entity (IE) holds investments in associates and subsidiaries through a pass-through/blocker entity (Holding), which is wholly owned by IE. Holding was set up for tax domicile purposes and has no function other than to hold investments on behalf of IE. The investment objective of the IE-Holding structure is to provide investment opportunities to investors. This is generally communicated to the investors in the prospectus.

Are services provided by Holdings IRS? Is Holdings an investment entity?
Does Holding provide investment–related services?
IFRS 10.B85C states “An investment entity may provide investment-related services (IRS) (eg investment advisory services, investment management, investment support and administrative services), ....”

The following is an additional excerpt from BC272:
The Investment Entities ED proposed that an investment entity would measure all of its subsidiaries at fair value (except for those subsidiaries providing investment-related services), even those investees who were themselves investment entities. Some respondents questioned this proposal and suggested that some investment entity subsidiaries should be consolidated (eg, wholly-owned investment entity subsidiaries that are created for legal, tax or regulatory purposes). However, the Board thinks that fair value measurement of all an investment entity’s subsidiaries (except for those subsidiaries providing investment-related services or activities) would provide the most useful information and therefore decided to retain this proposal...

BC272 can be read as excluding legal, tax and regulatory motivations as IRS and may make a distinction between passive and active IRS. Tentative view - achieving tax efficiencies is not an IRS

Does Holding qualify as an investment entity?
IFRS 10 allows the evaluation of the essential elements and typical features by considering IE and Holding as a combined entity – accordingly, Holdings would be an investment entity

What are the implications of this?
ACCOUNTING FOR INVESTMENT ENTITIES THAT ALSO PROVIDE IRS

• Some would argue that the non-consolidation exception in IFRS 10.32 and the guidance in IFRS 10.B85C was intended to apply to subsidiaries that ONLY provide IRS and therefore Holdings would be recognized at FV

• Others would argue that an investment entity may provide also IRS and therefore if an IE (Holdings) provided IRS, it would also be consolidated
  • Additional questions emerge as to whether the IRS needs to be significant/active (i.e., more than simply holding an brokerage account)
  • Impact is broader than whether there is one investment on IE’s books (Holdings) or whether there are many investments on IE’s books
    • May impact FV measurement as a different unit of account. If S1 is consolidated, then each underlying investment is a separate unit of account. If S1 is accounted for at FVTPL, then the investment in S1 is a unit of account (eg. based on NAV of S1). The resulting cumulative fair value may not always be identical
    • Impacts the recognition of deferred income taxes on inside basis differences
Issue has arisen re IFRS 10.B85H when master fund in a master-feeder structure was not formed in connection with the feeder fund.

X is a closed-ended investment fund (feeder fund). S1 (the master fund) has investments in a controlled entity (A) and in a pool of assets (Pool 1).

X and S1 were not formed at the same time. Instead, X acquired S1 at a later stage in order to gain access to the underlying investments held by S1.

X has no exit strategy for S1. S1 has exit strategy for the underlying investments.
A strict reading of IFRS 10.B85H would result in X not being an investment entity, as it would not have an exit strategy of S1 and X could not consider S1’s exit strategy in respect of its investees as S1 was not formed in connection with X.

Implication is that if X is not an investment entity:

• It would not qualify for the consolidation exemption and would consolidate S1.

• While S1 could account for A (controlled investee) at FV in its own accounts, for purposes of X’s consolidated financial statements, the exemption applicable to S1 would not be applicable to X and entity A would need to be consolidated.
WHAT IS THE UNIT OF ACCOUNT FOR FV MEASUREMENT?

Investment as a whole

- FV of entire investment.
- Includes a control premium for controlled investees.

Individual share

- Share price x number of shares.
- Excludes a control premium for controlled investees.

IASB is considering
• Some regulated investment companies are currently applying AcG-18 only because registered under NI 81-106
  • May not qualify as investment entities under IFRS 10 (e.g. mortgage investment corporations)
  • This aspect of adopting IFRS in 2014 may not be significant given they may not have any controlled investees

• Most other investment companies within the scope of AcG-18 would generally be expected to meet the requirements of an investment entity with real estate funds requiring the most judgement

• Will be an impact for certain non-investment company parents who were able to meet the conditions in AcG-18 to have its investment company subsidiary’s fair value accounting preserved in its own accounts
Key expected differences include:
- All US funds will go to this standard (not just those with controlled investments)
- Differences in the definition of an investment entity:
  - Regulated funds will automatically be an Investment Entity (similar to AcG-18)
  - Does not require an exit strategy for investments held for investment income returns
  - Requires that an entity manage (rather than measure) investments on a fair value basis
  - Precludes an entity that provides substantive investing-related services to third parties from being an investment entity
- Real estate investment trusts are excluded from the scope of US standard; industry practice of applying measurement principles for investment companies is expected to continue
- Non-investment company parent retains investment company accounting
- Does not specifically address if an investment company is required to consolidate another investment company which it controls
- Provides a practical expedient that allows use of NAV to measure FV