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Consolidation exception for qualifying investment entities

The IASB's[1] proposed amendments to IFRS 10 *Consolidated Financial Statements* are a reaction to constituents' support for a consolidation exception for investment funds, expressed in comment letters during the development of IFRS 10. Exposure Draft *Investment Entities* was issued by the IASB on 25 August 2011, with a comment deadline of 5 January 2012.

The FASB[2] is expected to issue a similar Proposed Accounting Standards Update in the near future; however, the proposals may differ in the key area of reporting at the level of the parent, which we explore below.

Aligning internal and external reporting

The amendments would require investment entities (as defined) to measure their investments in controlled entities at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*, rather than consolidating those investments.

The IASB considered this amendment jointly with the FASB (US GAAP has historically had a somewhat similar exemption) and agreed with constituents that consolidated financial information may not be the most useful information to be reported by investment funds. 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 with external financial reporting the way in which investments are managed and their performance evaluated internally.

Exception not carried through to the parent

If the parent of the investment entity is not itself an investment entity, then it would consolidate the investments accounted for at fair value in the investment entity's own consolidated financial statements. The IASB explains that it expects,

Highlights

- Investment entities would measure investments in controlled entities at fair value through profit or loss
- Exception would not be carried through to a parent that is not itself an investment entity
- Criteria to qualify would encompass: nature of activities, nature of investors and their interests in the entity, and the entity's management of its investments
- Additional disclosure requirements would be introduced
- Changes in status would be accounted for prospectively

Our forthcoming publication *New on the Horizon: Investment entities* will provide more detail about the proposals and discuss possible application issues. Speak to your usual KPMG contact if you would like a copy of this publication.

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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. Furthermore, it is not unrealistic to envisage situations in which the investment manager will consolidate an investment fund under IFRS 10, and therefore would be required to consolidate all subsidiaries accounted for by the investment entity at fair value. This means that any cost saving would be lost because consolidation would still be required, just at a higher level.

Unlike the IASB's proposals, the forthcoming FASB Proposed Accounting Standards Update may carry the consolidation exception through to the level of a parent that is not itself an investment entity.

Not all investment funds would qualify

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

- 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.
- The fund issues units that represent an entitlement to a proportionate share of the fund's 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 investment fund (if any).
- Substantially all investments of the fund are managed, and their performance evaluated, on a fair value basis.

We expect that private equity funds, master feeder structures, investment funds that hold the significant portion of the equity tranches of CDO/CLO[3] or similar vehicles, real estate funds, and funds of funds would benefit most from the amendments. However, the criteria in the proposals are very detailed and will require careful analysis.

Business purpose restricted

The proposals require that the *only* substantive activity of an investment entity be to invest for the purpose of capital appreciation and/or investment income. Furthermore, an investment entity would have to make an explicit commitment to a group of investors regarding this business purpose. All other activities, such as product or service co-development, production and marketing, or financing guarantees or collateral provided by the investee, would be prohibited in qualifying as an investment entity. The IASB's intention is that an investment entity should not obtain any benefits from subsidiaries that would be unavailable to other unrelated investors.

Exit strategies required

An investment entity would need a documented potential exit strategy as part of its investment strategy. The identified strategy would depend on the nature and objectives of the investment.

Exceptions to investment activities

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

Exception for collateral held

If an investment entity obtains collateral 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 a default would be accounted for in accordance with the applicable IFRS.

Multiple investments can be held indirectly

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).

Unit ownership needs to represent an identifiable portion of net assets

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.

Single investor acceptable in some cases

In general an investment entity would need to have multiple unrelated investors who together hold a significant share of ownership. However, 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

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investor (feeder fund) that is itself an investment entity, then the master fund would meet the definition of an investment entity, provided that all other criteria are met.

Disclosures expanded

IFRS 7 *Financial Instruments: Disclosures*, IFRS 12 *Disclosure of Interests in Other Entities* and IFRS 13 *Fair Value Measurement* would apply to subsidiaries of an investment entity that are measured at fair value through profit or loss. Additionally, the exposure draft proposes disclosures related to an entity's status as an investment entity, including:

- financial or other support provided or intended to be provided to subsidiaries without a contractual requirement to do so; and
- the nature and extent of any significant restrictions on the ability of subsidiaries to transfer funds to the investment entity.

Changes in status accounted for prospectively

When an entity qualifies for the exception for the first time, or ceases to qualify, it would account for the change prospectively. IFRS 3 *Business Combinations* would apply in consolidating investees that are businesses for the first time.

Consequential changes for equity-accounted investees

IAS 28 (2011) *Investments in Associates and Joint Ventures* would be amended so that the current option for venture capital organisations and similar entities to measure investments in associates and joint ventures at fair value through profit or loss would be replaced by a mandatory exception for investment entities. Unlike in the case of subsidiaries, this measurement exception would be carried through to the parent's (investor's) consolidated financial statements.

Effective date expected to be aligned with IFRS 10

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 full suite of consolidation and related standards[4] at the same time.

The effect of applying the amendments at the date of adoption would be recognised as an adjustment to retained earnings at the beginning of that period, i.e. comparatives would not be adjusted.

Abbreviations and definitions

1 IASB: International Accounting Standards Board

2 FASB: US Financial Accounting Standards Board

3 CDO/CLO: Collateralised debt obligation/Collateralised loan obligation

4 IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, IFRS 12 *Disclosure of Interests in Other Entities* and IAS 28 (2011) *Investments in Associates and Joint Ventures*

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