The International Accounting Standards Board (IASB) has issued an amendment to IFRS 10 Consolidated Financial Statements to provide an exception to the consolidation requirement for entities that meet the definition of an investment entity. The exception to consolidation requires investment entities to account for subsidiaries at fair value through profit or loss in accordance with IFRS 9 Financial Instruments.

Definition of an investment entity
An investment entity is an entity that:

a) Obtains funds from one or more investors for the purpose of providing those investor(s) with professional investment management services;

b) Commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and

c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

The application guidance to IFRS 10 clarifies that an entity must consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. An entity must meet all three elements of the definition to be an investment entity. The application guidance describes the elements of the definition in more detail. We highlight some of this guidance below.

Business purpose
The purpose of an investment entity is to invest solely for capital appreciation, investment income or both. An investment entity may provide investment-related services to third parties as well as to investors, even if those activities are substantial to the entity. An investment entity may also participate in the following activities, provided they are undertaken to maximise investment returns and do not represent a separate substantial business activity or separate substantial source of income:

a) Providing management services and strategic advice to an investee

b) Providing financial support to an investee
Investment entities – exception to consolidation

How we see it
The pre-ballot draft proposed that an entity would not qualify as an investment entity if the investment entity provided substantive investment-related services to third parties. However, some respondents, as well as the IASB staff, were concerned that this would exclude a number of private equity companies that should qualify as investment entities. Therefore, the final amendment does not disqualify an entity from being an investment entity only because it provides substantive investment-related services to third parties.

Exit strategies
As investment entities do not hold investments indefinitely, there must be an exit strategy documenting how the entity intends to realise substantially all its equity investments and non-financial asset investments.

How we see it
Earlier drafts of the amendments had proposed that an entity must have an exit strategy for substantially all its investments. However, concerns were raised that entities holding substantial amounts of debt investments to maturity could be disqualified. The final amendment focuses on the fact that investment entities do not hold their investments indefinitely. Therefore, an exit strategy for debt investments will not normally be required if such investments have a set maturity date.

Earnings from investments
An entity is not an investment entity if it has the objective of obtaining benefits from its investments other than capital appreciation and investment income, such as the acquisition of intangible assets or technology of an investee.

Fair value measurement
An investment entity must demonstrate that fair value is the primary measurement attribute used. The fair value information must be used internally by key management personnel and must be provided to the entity’s investors.

In order to meet this requirement, an investment entity would:

a) Elect to account for investment property using the fair value model in IAS 40 Investment Property
b) Elect the exemption from applying the equity method in IAS 28 for investments in associates and joint ventures, and
c) Measure financial assets at fair value in accordance with IFRS 9.

Typical characteristics of an investment entity
In assessing whether an entity meets the definition of an investment entity as described above, the entity must consider whether it has the following typical characteristics:

- It has more than one investment, to diversify the risk portfolio and maximise returns;
- It has multiple investors, who pool their funds to maximise investment opportunities;
- It has investors that are not related parties of the entity; and
- It has ownership interests in the form of equity or similar interests.

The absence of one or more of these typical characteristics does not necessarily disqualify an entity from being an investment entity. If the entity does not have all of the typical characteristics, it must provide additional disclosure according to a consequential amendment to IFRS 12 (see ‘Disclosures’ later in this document).
Exception to consolidation

An investment entity does not consolidate its subsidiaries and does not apply IFRS 3 Business Combinations when it obtains control of an entity. Instead, an investment entity is required to measure subsidiaries at fair value through profit or loss in accordance with IFRS 9.

Investment-related services

Although investment entities will generally not consolidate subsidiaries, there is one exception to this. If an investment entity has a subsidiary that provides investment-related services, such as investment management services, to the entity or other parties, then the investment entity must consolidate its subsidiary.

Investment entity parent of an investment entity

An investment entity will measure all of its investments in subsidiaries at fair value, even if those investees are themselves investment entities. This includes both master-feeder structures and fund-of-funds structures.

Parent entities that are not investment entities

The exception to consolidation applied by investment entities is not retained by parent entities that are not themselves investment entities. That is, a parent entity that is not an investment entity itself is not permitted to apply the investment entity accounting in its consolidated financial statements. Instead, it must consolidate all entities that it controls, including those controlled through an investment entity (see diagram).

How we see it

The majority of the respondents to the exposure draft (ED) of the proposals supported allowing the roll-up of the investment entity accounting, arguing that fair value information is more relevant at the parent entity level than at the investment entity level. However, the Board decided not to permit this, largely due to the structuring opportunities it may create.

The Board also noted that this will create a difference compared to US GAAP, which requires a non investment entity parent to retain the fair value accounting used by an investment entity subsidiary.

Associates and joint ventures held by an investment entity

As discussed above, an investment entity must elect the exemption from the equity method in IAS 28 for interests in associates and joint ventures. However, differently from the exposure draft, entities that are venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities, will still be permitted to elect to measure investments in associates and joint ventures at fair value in accordance with IFRS 9.

Illustrative examples

IFRS 10 includes four illustrative examples of the application of the definition and the typical characteristics to determine whether an entity is an investment entity.

Disclosures

In addition to the amendments to IFRS 10, IFRS 12 has also been amended to require additional disclosures for investment entities.

Investment entities must disclose:

- The significant judgements and assumptions it has made in determining how an entity meets the definition of an investment entity
- Information relating to each unconsolidated subsidiary, including:
  - Subsidiary name
  - Country of incorporation or residence
  - Proportion of ownership interest held and the proportion of voting rights held
- Details of the following:
  - The restriction of subsidiaries to transfer funds to the investment entity
  - Any financial support the investment entity has provided to subsidiaries
  - The terms of contractual arrangements with a structured entity.

Investment entities - exception to consolidation
Effective date
The amendment applies for annual periods beginning on or after 1 January 2014. Earlier application is permitted.

How we see it
The amendment applies one year later than IFRS 10. Since early application is permitted, entities can elect to apply the amendment at the same time as it applies IFRS 10.

However, entities will need to consider how much planning and preparation time will be needed to update systems and processes to potentially de-consolidate previously consolidated investment entities and to comply with the new disclosure requirements.

Transition
At the date of initial application (the beginning of the annual reporting period in which the amendment is applied for the first time), an entity will assess whether it meets the definition of an investment entity, based on facts and circumstances that exist at that date. If it is an investment entity, it measures the investment in each subsidiary at fair value through profit or loss as if the amendment had always been effective.

The investment entity retrospectively adjusts both the annual period immediately preceding the date of initial application and equity at the beginning of the immediately preceding period for the difference between:
- The previous carrying amount of the subsidiary, and
- The fair value of the investment entity's investment in the subsidiary.

Comparison with US GAAP
The Financial Accounting Standards Board (FASB) is continuing to work on its amendments to the US GAAP definition of an investment company, which will bring US GAAP and IFRS further into alignment for investment entities. However, GAAP differences will remain, including the accounting by parent entities that are not investment entities as discussed above. The FASB intends to issue its final standard by the end of 2012.

How we see it
We believe that the amendment to IFRS 10 may simplify the accounting in the case of funds and similar entities that are investment entities as those entities generally will not consolidate entities that they control. However, it may have little to no effect on banks, insurers and many other organisations involved in investment activities. This is because the exemption can be applied only in the financial statements of investment entities themselves and not in the consolidated financial statements of groups that control such an entity.

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