

Paul Pacter: Investors, preparers and the IASB agree on consolidation exception for investment entities

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In October 2012 the IASB published amendments to its consolidation requirements changing the way in which investment companies (referred to in IFRSs as “investment entities”), such as private equity funds, venture capital funds, and other investment funds, will account for their investments in subsidiaries. Instead of requiring investment entities to consolidate the investments that they control, the new accounting will require them to measure those investments at fair value with changes in fair value recorded in profit or loss. The IASB believes that fair value information will better serve investors and other users of an investment entity’s financial statements than consolidated information. There will also be new note disclosures about such investments.

Summary of the Investment Entities project

The IASB undertook a project to change investment entity accounting in response to the many requests from investors who told them that consolidation does not provide useful or relevant information for investment entity financial statements. Those investors told the IASB that fair value, and information about how fair value is derived, is by far the most relevant measurement attribute for an investment entity’s investments. This is because investment entities use fair value to evaluate their investments, which take the form of pooling investors’ funds, investing those funds for returns only from capital appreciation and investment income.

The project resulted in amendments to *IFRS 10 Consolidated Financial Statements*, which was issued in May 2011 and would have required all entities, including investment entities, to consolidate all subsidiaries. The IASB has worked to a tight deadline to make those amendments—IFRS 10 goes into effect in January 2013. The amendments:

- define an investment entity;
- require that investment entities must carry their subsidiaries as investments, rather than consolidate them, and measure them at fair value through profit or loss;

- require that a non-investment entity parent of an investment entity subsidiary must consolidate all of its subsidiaries, even those controlled through an investment entity; and
- specify financial statement disclosures that investment entities with unconsolidated subsidiaries should make.

The amendments take effect from 1 January 2014, but investment entities can apply them earlier.

Main issues

In developing the amendments, the IASB considered many issues, including the following four main ones:

- Issue 1: How should investment entities account for their investments?
- Issue 2: Which entities should qualify as investment entities?
- Issue 3: Should a non-investment entity parent consolidate an investment entity subsidiary?
- Issue 4: What disclosures should investment entities make?

Issue 1: How should investment entities account for their investments?

The investment entities project arose as a result of the Consolidations project. Views received from interested parties on the IASB's Exposure Draft that preceded IFRS 10 indicated that, for the investment entity industry, fair value measurement of subsidiaries resulted in more relevant and useful information than consolidating those subsidiaries. Investors and investment entity preparers told the IASB that they evaluate all of an investment entity's investments on a fair value basis, so for them it would be most useful to have all investments recorded at fair value. Investors typically transact with an investment entity on a fair value basis, and investment entities also make their buy, sell and hold decisions for their investments on a fair value basis.

As a result, in their view consolidation of investment entity subsidiaries does not provide relevant or useful information, because it emphasises the cash flows and assets and liabilities of individual investees, and carries forward the historical cost measurement of an investee's assets and liabilities. Because of those deficiencies, investors said that they ignore the consolidated financial statements in favour of fair value disclosures, and preparers stated that preparing consolidated financial statements involved a lot of time and cost, with little benefit because investors do not use the information. Investors concurred.

For those reasons, the IASB decided that, instead of consolidation, investment entities should be required to measure their investments in subsidiaries at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement* if they do not yet apply IFRS 9).

The IASB also considered whether to provide comprehensive accounting guidance for all investments owned by investment entities, such as non-controlled investments. The IASB decided not to do so because, in most cases, existing IFRSs either require or permit entities to measure their investments at fair value. However, the IASB decided that for an entity to qualify as an investment entity, the entity must use existing fair value options in IFRSs (eg in IAS 28 *Investments in Associates* and IAS 40 *Investment Property*). That leads us to Issue 2.

Issue 2: Which entities should qualify as investment entities?

The IASB thinks that it is very important to specify clearly the appropriate population of entities that should be eligible for the exception from the fundamental principle in IFRS 10 that consolidation is the most meaningful presentation for controlled investments (ie subsidiaries).

The amendments to IFRS 10 resulted in the following definition of an investment entity, and aim to capture the business model and core activities of such entities.

An investment entity:

- obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- makes a commitment to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- measures and evaluates the performance of substantially all of its investments on a fair value basis.

The IASB has provided guidance on applying the definition by describing the 'typical characteristics' of an investment entity. A typical investment entity:

- has more than one investment;
- has more than one investor;
- has unrelated investors; and
- has ownership interests in the form of equity or similar interests.

An investment entity would normally have all of those typical characteristics, but that is not a requirement. If an entity does not meet one or more of these typical characteristics, it will need to use additional judgement in determining whether or not it meets the definition of an investment entity. In addition, investment entities that do not possess the typical characteristics need to disclose that fact and how they determined that they still qualify to be an investment entity.

Issue 3: Should a non-investment entity parent consolidate an investment entity subsidiary?

One of the most contentious issues that the IASB discussed was whether to allow a non investment entity parent to retain the fair value accounting used by an investment entity subsidiary. Many interested parties, especially preparers in industries in which entities are likely to have an investment entity subsidiary, such as banking and insurance, were strongly in favour of retaining at a non-investment entity parent level the fair value accounting used by an investment entity subsidiary. Those parties asserted that the fair value accounting used by an investment entity subsidiary is also relevant at a non investment entity parent level.

However, the IASB established the exception to consolidation because of the unique business model of investment entities. Non-investment entity parents do not have this unique business model. Consequently, the IASB concluded that a non-investment entity parent should be required to consolidate all of its subsidiaries, including those held through investment entity subsidiaries.

In addition, the IASB is concerned that a non-investment entity parent could avoid consolidation of a controlled investee by holding the controlled investee in an intermediary investment entity subsidiary. The IASB is concerned that this could lead to more 'off balance sheet debt' or to the ability to hide losses in unconsolidated subsidiaries.

Issue 4: What disclosures should investment entities make?

Information about an entity's investments and consolidation (or non-consolidation) is vital for users of financial statements. Because the IASB was establishing an exception to consolidation and requiring that investments would be measured at fair value, it decided to require investment entities to disclose the following:

- information about significant judgements or assumptions made in deciding whether the entity meets the definition of an investment entity;

- information about unconsolidated subsidiaries, including the name and location of those subsidiaries and the proportionate ownership interest that the investment entity has in those subsidiaries; and
- information required by IFRS 7 Financial Instruments: Disclosures, IFRS 13 Fair Value Measurement and IAS 24 Related Party Disclosures. For example, IFRS 13 requires an entity to provide information about how it measured fair value when using models rather than quoted prices.

The first two are now in IFRS 12 *Disclosure of Interests in Other Entities*.

Because the objective of the project was to provide an exception from consolidation, the IASB did not require additional disclosures about non-controlled investments. Instead, investment entities must follow the disclosure requirements in other IFRSs (including IFRS 7 and IFRS 13) for the remainder of their investments.

Joint deliberations with FASB

The IASB and the US Financial Accounting Standards Board (FASB) discussed the accounting for investment entities together. US Generally Accepted Accounting Principles (GAAP) already had comprehensive guidance on accounting by investment companies in Topic 946 *Investment Companies* in the FASB *Accounting Standards Codification*®. Topic 946 requires an investment company to measure all investments at fair value and it also contains comprehensive presentation and disclosure requirements for investment companies. Although the IASB and the FASB discussed the issues together, the scopes of their projects were different: the IASB was focused on introducing an exception from consolidation, whereas the FASB was focused on amending its existing comprehensive accounting and disclosure requirements for investment companies. However, the boards did come up with similar definitions for investment entities and now have a similar approach to determining whether an entity qualifies as an investment entity.

Respond to the author

Paul Pacter is a member of the IASB and a guest author of *Investor Perspectives*. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB/IFRS Foundation. The IASB/IFRS Foundation disclaims any and all responsibility.

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