Project	**Consolidation**
Topic	**Investment companies—consequential amendments to IAS 28 and IAS 31**

Introduction

1. At the February and April 2010 joint board meetings, the IASB and the FASB tentatively decided that:

    (a) an investment company should measure investments in entities that it controls at fair value through profit or loss.

    (b) an investment company is an entity that meets all of the following criteria:

        (i) Express business purpose. The express business purpose of an investment company is investing for current income, capital appreciation, or both.

        (ii) Exit Strategy. The entity has identified potential exit strategies and a defined time (or range of dates) at which it expects to exit the investment.

        (iii) Investment activity. Substantially all of the entity's activities are investment activities carried out for the purposes of generating current income, capital appreciation, or both. The entity and its affiliates (which includes any parent or fellow subsidiaries of the entity) shall not obtain benefits from its investees that would be unavailable to other investors or unrelated parties of the investee.

        (iv) Unit ownership. Ownership in the entity is represented by units of investments. The entity has significant third party investment (being investments other than those held by any parent of the entity or its subsidiaries).

(v) Pooling of funds. The funds of the entity's owners are pooled so that owners can avail themselves collectively of professional investment management.

(vi) Fair value. All of the investments are managed, and their performance is evaluated (both internally and externally), on a fair value basis.

(vii) Reporting entity. The entity must be a reporting entity.

(viii) Debt. Any providers of debt to the investees of the entity shall not have direct recourse to any of the entity's other investees.

(c) the fair value measurement basis for controlled investees applied by an investment company should be retained in the consolidated financial statements of a parent of an investment company.

2. Both IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* contain a scope exemption for venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds. Such entities do not have to apply the equity method to investments over which they have significant influence or joint control if they elect to account for these investments in accordance with IFRS 9 *Financial Instruments* / IAS 39 *Financial Instruments: Recognition and Measurement* and measure them at fair value through profit or loss.

3. The purpose of this paper is to ask whether:

(a) The scope exemption in IAS 28 and IAS 31 should be amended to apply to investment companies as defined in the consolidation project; and

(b) Whether such investment companies should be *required* rather than allowed to measure investments in entities over which they have significant influence or joint control at fair value through profit or loss.

Staff analysis and recommendations

Definition of an investment company

4. IAS 28 and IAS 31 do not define venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds. In contrast, as part of the consolidation project, the boards have extensively deliberated the definition of an investment company and the criteria to evaluate whether an entity meets this definition and thus is required to apply the consolidation exemption.

5. The difference in the approach applied reflects the Board's long-standing view that more rigour is required to justify an exemption from the consolidation of controlled entities. Consolidation results in the recognition of the underlying assets and liabilities of the controlled investee; fair value measurement results in the recognition of a 'one-line' investment in the controlled investee. Therefore, a decision about whether to consolidate an investment in an investee affects the recognition, as well as the measurement, of assets and liabilities.

6. In contrast, when an entity has significant influence over or joint control of an investee, the difference between using the equity method or fair value to measure investments in an investee does not affect the recognition of assets and liabilities; rather, it affects the measurement basis used to measure that entity's investment in the investee.

7. For this reason, some might argue that the tentative decisions taken by the Board regarding investments in controlled investees of an investment company should not necessarily affect the current scope exemption in IAS 28 and IAS 31 for venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds.

8. Additionally, if the stricter criteria developed by the Board to define an investment company for the purposes of consolidation is also applied within IAS 28 and IAS 31, potentially fewer entities would qualify for the scope exemption than are currently making use of the exemption within these standards. Some

might question why we would wish to limit the use of fair value through profit or loss as a means of measuring an investment in equity instruments.

9. Nevertheless, we recommend that the Board include the proposed criteria for an investment company, developed within the consolidation project, in IAS 28 and 31 (to replace the list of entities referred to in the scope paragraphs of IAS 28 and 31) for the following reasons:

    (a) The criteria developed within the consolidation project for an investment company and the list of entities currently referred to in the scope paragraphs in IAS 28 and 31 have the same objective—to identify those entities for which fair value measurement of their investments provides more relevant information. The recommendation will increase consistency because the same population of entities would be considered investment companies across IFRSs; this should increase comparability for users of those financial statements.

    (b) The definition of an investment company in US GAAP is used for all of an investment company's investments, regardless of whether the investment company controls, has significant influence or jointly controls an investee. The staff recommendation more closely aligns IFRS with US GAAP in this respect.

10. We would also recommend that a question is included in the investment company ED to specifically request constituents' comments on the potential consequences of amending IAS 28 and IAS 31 in this respect.

Required or permitted

11. IAS 28 and IAS 31 do not require, but permit, entities meeting the current scope exemption to fair value investments over which they have significant influence or joint control. Although the staff believe that the types of entities listed within the scope exemption would rarely, if ever, choose to use the equity method rather than fair value to measure their investments within the scope of IAS 28 and IAS 31, the choice does exist. In developing the requirements for investment companies as part of the consolidation project, the Board has

tentatively decided that an entity that meets the definition of an investment company is *required* to measure investments in entities that it controls at fair value through profit or loss. This was considered appropriate as it would provide more comparable information to the users of financial statements. This treatment is also consistent with US GAAP.

12. The staff recommend that the Board align IAS 28 and IAS 31 with the proposed requirements for investment companies developed within the consolidation project by requiring an entity that meets the definition of an investment company to measure investments in entities over which it has significant influence or joint control at fair value through profit or loss. Again, this would also have the benefit of more closely aligning the IFRS requirements with those in US GAAP for investment companies.

Questions for the Board

(1) Does the Board agree to include the proposed criteria for an investment company, developed within the consolidation project, in IAS 28 and 31 (to replace the list of entities referred to in the scope paragraphs of IAS 28 and 31)?

(2) Does the Board agree that an investment company should be required to measure investments over which it has significant influence or joint control at fair value through profit or loss?