STAFF PAPER

July 2012

[REG] IASB Meeting

Project	**Investment Entities**
Paper topic	Sweep issues

CONTACT(S)	Sarah Geisman	sgeisman@ifrs.org	+44 (0)20 7246 6464
	Rachel Knubley	rknubley@ifrs.org	+44 (0)20 7246 6904

Objective

1. This paper discusses the following sweep issues that need to be resolved before finalising the investment entity requirements:

   (a) initial measurement of controlled investees and investments in associates and joint ventures;

   (b) measurement of all investment assets held by an investment entity;

   (c) the use of an net asset value ('NAV') practical expedient for fair value;

   (d) whether the definition of an investment entity should include a reference to existing regulatory requirements; and

   (e) whether an investment entity should be allowed to provide financial support to its investees.

2. For each issue, the staff provide a summary of the background of the issue and the feedback received, along with the staff analysis and recommendation.

Summary of staff recommendations

3. The staff recommend that:

(a) an investment entity's controlled investees and investments in associates and joint ventures should be initially measured at fair value in accordance with IFRS 9 *Financial Instruments;*

(b) the investment entities requirements should not provide any measurement guidance for non-financial assets held by an investment entity;

(c) the IASB should not pursue the introduction of an NAV practical expedient for fair value in the scope of the investment entities project;

(d) the definition of an investment entity should not include any reference to existing regulatory requirements; and

(e) an investment entity should be allowed to provide financial support to its investees.

Initial measurement of controlled investees and investments in associates and joint ventures

Background and feedback received

4. The *Investment Entities* exposure draft ('the IASB ED') proposed that an investment entity would measure controlled investees and investments in associates and joint ventures at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*. The IASB ED did not give any specific guidance regarding initial measurement.

5. IFRS 9 requires that, if a financial asset is subsequently measured at fair value through profit or loss, it is initially measured at fair value and that transaction costs are expensed. In addition, IFRS 13 *Fair Value Measurement* explicitly states that fair value should not be adjusted for transaction costs.

6. However, IAS 40 *Investment Properties* requires that an investment property be initially measured at cost, including transaction costs, even if it is subsequently measured at fair value through profit or loss.

7. In US GAAP, Topic 946 currently requires investment companies to initially measure their investment assets at transaction price (including transaction costs)

and subsequently measure those investment assets at fair value. Transaction costs would therefore be recognised as part of the investment company's unrealised gains/losses.

8. The May 2010 ED for the FASB's *Accounting for Financial Instruments* project proposed that investment companies would be required to initially measure their financial assets at fair value. In light of constituent feedback received on the Exposure Draft, during redeliberations the FASB decided to continue to require investment assets of investment companies to be measured at transaction price, including transaction costs.

9. Relatively few constituents mentioned initial measurement and the treatment of transaction costs in their responses to the IASB ED. Those constituents that did mention the issue, however, requested clarification of the treatment of transaction costs. Constituents also noted the inconsistency in the treatment of transaction costs between IFRS 9, IFRS 13 and IAS 40. Some constituents argued that capitalising transaction costs, similarly to IAS 40, and subsequently recognising those costs as fair value losses, is more appropriate for investment entities. Some of these constituents argued that this initial measurement should be used for all investments of an investment entity, while others argued that the initial measurement should be used for the controlled investments of an investment entity.

Staff analysis and recommendation

10. The staff acknowledge the inconsistency between IAS 40, IFRS 9, IFRS 13 and US GAAP in terms of the treatment of transaction costs. The staff considered whether to require investment entities to measure all their investments in the same way at initial recognition (including specifying the treatment of transaction costs). However, the staff think that it is outside the scope of the IASB's investment entities project to provide comprehensive initial measurement guidance for all investments held by investment entities, given that the objective of the project is to provide accounting guidance only for controlled investees and investments in associates and joint ventures held by investment entities.

11. The staff also considered specifying that controlled investees and investments in associates and joint ventures should be initially measured at transaction price, including transaction costs. However, the staff do not recommend this approach because it would be inconsistent with the guidance in IFRS 13, which specifies that fair value does not include transaction costs (along with the financial instruments initial measurement guidance in IFRS 9). Moreover, only requiring that controlled investees (and not any other investments) should be initially measured at fair value including transaction costs would not fully address the requests of constituents who wanted all investments to be initially measured at fair value including transaction costs.

12. The staff recommend that the IASB should confirm the proposal in the IASB ED to measure all controlled investees and investments in associates and joint ventures at fair value through profit or loss in accordance with IFRS 9. Accordingly, an investment entity would initially measure its controlled investees and investments in associates and joint ventures at fair value and immediately expense transaction costs.

Question 1
Does the IASB agree with the staff recommendation that the IASB should confirm the proposal in the IASB ED to initially measure all controlled investees and investments in associates and joint ventures at fair value in accordance with IFRS 9?

Measurement of all investment assets held by investment entities

Background and feedback received

13. The IASB ED only proposed measurement guidance for the controlled investees and investments in associates and joint ventures held by investment entities, requiring investment entities to measure those investments at fair value through profit or loss in accordance with IFRS 9. It also contained a ‘fair value management’ criterion that an entity would have to meet to qualify as an investment entity. As part of the application guidance for that criterion, the

exposure draft stated that an entity would have to elect the fair value option in IAS 40 to meet the 'fair value management' criterion.

14. Many constituents requested that the final guidance include more comprehensive measurement guidance for all investments held by an investment entity, stating that all investments should be measured at fair value through profit or loss. Some of these constituents acknowledged that the existing measurement guidance in IAS 40, IAS 41 *Agriculture* and IFRS 9 would allow or require an investment entity to measure most of its investments at fair value. However, these constituents noted that there is no guidance for certain non-financial investments held by investment entities, such as artworks or commodities such as gold bullion.

Staff analysis and recommendation

15. Again, the staff think that it is outside the scope of the Investment Entities project to provide comprehensive measurement guidance for all investments held by an investment entity. The IASB set out to provide an exception from consolidation for investment entities, not to provide comprehensive accounting guidance for all investments held by investment entities.

16. Moreover, the staff think that in most cases, existing IFRSs can be followed to ensure that all investments held by an investment entity are measured at fair value. For example, investment entities will need to elect the fair value option in IAS 40 to prove that they meet the 'fair value management' component of the definition. In addition, by virtue of meeting the 'fair value management' component of the investment entity definition, an investment entity's financial assets will be required to be measured at fair value through profit or loss in accordance with IFRS 9. The guidance in IFRS 9 (as currently published and following the project to make limited modifications) requires an entity to measure financial assets at fair value if those financial assets are held in a business model in which the financial assets are managed and their performance evaluated on a fair value basis.

17. The staff note that there is nothing in IFRSs prohibiting an investment entity from measuring its non-financial investments at fair value. The staff do not think investment entities would have any reason to measure their non-financial

investments at anything other than fair value when the rest of their investments are measured at fair value.

18. Consequently, the staff do not recommend that the IASB should include any measurement guidance for investments other than controlled investees and investments in associates and joint ventures in the final investment entity requirements. The staff note that they are not proposing that the application guidance relating to IAS 40 should be removed from the investment entity requirements.

Question 2
Does the IASB agree with the staff recommendation that the investment entities requirements should not include any measurement guidance for investments other than controlled investees and investments in associates and joint ventures?

NAV practical expedient

Background and feedback received

19. Topic 820 *Fair Value Measurement* in in the *FASB Accounting Standards Codification*® allows an investor in an investment company to use the reported net asset value ('NAV') per share of that investment company as a practical expedient for fair value in certain circumstances.

20. IFRS 13 *Fair Value Measurement* has no such practical expedient. In the Basis for Conclusions of IFRS 13, the IASB explained that they did not provide a similar practical expedient because:

    (a) there is no specific accounting guidance for investment companies; and

    (b) there are different practices for calculating net asset values in jurisdictions around the world.

21. Relatively few respondents commented on this issue. However, some constituents did note the difference between IFRSs and US GAAP. These constituents requested that the IASB should now provide similar guidance allowing NAV to be used as a practical expedient for an investor's interest in an investment entity.

Staff analysis and recommendation

22. The staff note that one advantage of providing a NAV practical expedient would be that such an expedient would increase convergence with US GAAP. The FASB staff have heard from US constituents that this practical expedient works well in practice and provides needed relief to entities accounting for their investments in investment companies.

23. The staff also note that part of the IASB's initial rationale for not including such a practical expedient is no longer valid (that is, following the finalisation of the investment entities project there will now be a definition of an investment entity and some accounting guidance for investment entities in IFRSs).

24. However, the staff have concerns about introducing such a practical expedient to IFRS 13. It is outside the scope of the investment entities project to provide fair value measurement guidance for investments in investment entities. In addition, the definition of an investment entity was developed within the context of giving investment entities an exception from consolidation guidance. The staff also have concerns about entities that may not have controlled investees using this definition to determine whether they are eligible for the NAV practical expedient. The definition was not designed for this purpose.

25. Moreover, the staff think that the IASB's concern that NAV could be calculated differently in different jurisdictions is still a valid concern.

26. Consequently, the staff do not recommend introducing an NAV practical expedient for fair value measurement within the context of the Investment Entities project. If the IASB is interested in pursuing such a practical expedient, the staff recommend doing so in a separate project.

Question 3
Does the IASB agree with the staff recommendation that the IASB should not introduce an NAV practical expedient for fair value measurement within the context of the Investment Entities project?

Referencing existing regulatory requirements

Background and feedback received

27. The FASB's proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements* proposed that an entity that is regulated as an investment company under the SEC's *Investment Company Act* of 1940 (the 1940 Act) would be an investment company for accounting purposes and would not be required to assess the proposed criteria. In contrast, the IASB ED had no reference to regulatory requirements in guidance about the determination of investment entity status.

28. IASB constituents noted the difference in scope between the IASB ED and the FASB ED regarding entities regulated as investment companies. Some constituents requested that the IASB should include a reference to existing regulatory requirements in its guidance to allow an entity that is regulated as an investment entity to fall within the scope of the IASB's proposed guidance on investment entities. Other constituents, however, explicitly cautioned the IASB against following such an approach, stating that global accounting standards should not rely on the regulatory environment and requirements in different jurisdictions.

Staff analysis and recommendation

29. The staff note that the FASB's reference to the 1940 Act represented one of the points of difference between the IASB ED and the FASB ED. The FASB introduced the reference to regulatory requirements, in part, to reduce the costs of complying with two sets of requirements (regulatory requirements and accounting requirements). However, the IASB staff are still of the opinion that it is not appropriate for the definition of an investment entity in IFRSs to be linked to regulatory requirements.

30. The staff are concerned that the regulatory requirements in different jurisdictions may result in similar entities qualifying as an investment entity in one jurisdiction, but not in another. The staff are also concerned that regulatory requirements may

change over time, resulting in an ever-changing population of entities that would be eligible for an exception from consolidation. Moreover, the staff are concerned that referring to regulatory requirements could result in entities that the IASB does not think should be eligible for the exception to consolidation nevertheless qualifying as an investment entity. The IASB would have no way to control the population of investment companies because this would effectively be left to regulators.

31. Consequently, the staff recommends that the proposed definition of an investment entity should stand on its own without any reference to existing regulatory requirements. The staff believe the definition of an investment entity should only include those entities that the IASB believes should qualify for the exception from consolidation without relying on regulators' decision-making.

Question 4
Does the IASB agree with the staff recommendation that the definition of an investment entity should not make reference to existing regulatory requirements?

Provision of financial support

Background and feedback received

32. The IASB ED does not explicitly state whether an investment entity could provide financial support, such as loans or guarantees, to its investees. However, the IASB ED does contain disclosure requirements relating to the provision of financial support.

33. Some IASB constituents suggested that an investment entity should be prohibited from providing financial support in the form of guarantees or loans to its investees. Those constituents argue that providing such support would mean that an entity would effectively be engaging in financing activities in addition to investing activities and correspondingly be receiving benefits beyond capital appreciation or investment income. If an investment entity provides guarantees to its investees, it may also be unable to unilaterally exit its investment. Those

respondents also argued that the fact that there is additional risk for the investment entity as a result of the lending means that consolidated information would be much more relevant for controlled investees.

34. Some IASB constituents stated that there are numerous cases in the private equity and venture capital industry in which an investment entity does provide financing to investees, either in the form of loans or guarantees. Those constituents argue that these activities are investing-related activities because they are meant to increase the fair value of the investee and therefore increase the capital appreciation that the investment entity would ultimately receive from selling the investee. Those constituents argue that the leverage of the investee is reflected in its fair value. Furthermore, some constituents stated that in some cases investment funds are required to provide guarantees to investees because of the legal and tax requirements in certain jurisdictions.

Staff analysis and recommendation

35. It can be argued that providing financial support, especially in the form of guarantees, to an investee should disqualify an entity from investment entity status. The fact that there is recourse to the investment entity for the debt of the investee means that leverage information would be more relevant. In addition, it can be argued that these financing activities would be activities other than investing, which would be prohibited for investment entities.

36. The staff would not recommend stating that an investment company would be prohibited from providing financial support to an investee. The staff believe that it is common for an investment entity to provide some financial support to an investee, such as a loan or a capital commitment. This support is given in order to achieve their ultimate goal of increasing the capital appreciation or investment income to be received from that investment. The staff note that prohibiting financial support to investees would mean that an investment entity could only engage in investments through equity investments and not through debt financing. The staff think that the type of investment made should not be a consideration when determining whether the entity is an investment company. In addition, there

could be practical issues in distinguishing between a debt investment and equity investment.

37. It could be argued that an entity such as a bank could be included within the scope of the investment entities guidance if the boards decided to allow an investment entity to provide financial support to its investees. However, the staff note that an investment entity must hold its investments for returns from capital appreciation, or capital appreciation or investment income. The staff think that financial institutions such as banks do not provide financial support solely to invest for returns from capital appreciation, or capital appreciation and investment income. Instead, one of the substantive activities of a bank is originating loans (lending activities) for returns through interest income and fees, which would be inconsistent with the requirement that an investment company's only substantive activities must be investing. The staff think that there is a clear difference between a private equity fund providing financial support to an existing equity investee and a bank lending money to an unrelated party. In the former case, the fund is providing financial support in order to increase the fair value of its investee and realise maximum capital appreciation and investment income through its investment. In the latter case, the bank is lending money as a stand-alone business activity.

38. The staff also considered specifically prohibiting the provision of *guarantees* (as opposed to any financial support) by an investment entity to an investee. However, the staff again think that this activity can be considered to be consistent with the overall investing activities in which an investment entity engages. In addition, the staff note that the investment entity will have to make disclosures regarding any guarantees or other financial support that it provides to its investees. Disclosures regarding financial support are discussed further in Agenda Paper 8E.

39. Again, the staff do not recommend that an investment entity should be prohibited from providing financial support to its investees so long as the provision of the financial support does not constitute a separate substantive activity of the entity.

Question 5
Does the IASB agree with the staff recommendation that an investment entity should be allowed to provide financial support to its investees so long as the provision of financial support does not constitute a separate substantive activity of the entity?