STAFF PAPER

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Project	**Investment Entities**
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Introduction

1. Exposure Draft ED/2011/4 *Investment Entities* (the ED) proposed that an entity shall reassess whether it meets the criteria to be classified as an investment entity if facts and circumstances indicate that there are changes to one of more of the criteria used to determine investment entity status. If the reassessment shows that an entity's status has changed, the ED proposed that an entity shall account for the change prospectively from the date of the change.

2. The purpose of this agenda paper is to analyse whether those proposals should be amended taking into account respondents' comments about the ED.

3. This paper:

   (a) explains the reassessment requirements proposed in the ED;

   (b) summarises respondents' comments on the proposed requirements in the ED;

   (c) discusses the staff analysis and recommendations for reassessment of investment entity status and how to account for any change identified; and

   (d) considers the disclosures required when a change in investment entity status is recognised.

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Reassessment requirements proposed in paragraphs 3-5 of the ED

4. The IASB ED proposes that an entity reassess whether it meets the criteria to be an investment entity if facts and circumstances indicate that there are changes to one or more of the criteria. The FASB's proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements* (the FASB ED) proposed that an entity reassess whether it is an investment entity if the purpose and design of that entity changes.

5. The IASB ED proposes that an entity that no longer meets the definition of an investment entity accounts for the change in its status prospectively by changing the accounting for its investments from the date when the change in status occurred. This would require an entity to apply IFRS 3 *Business Combinations* to those investees that are required to be consolidated as a result of the entity no longer qualifying as an investment entity. The FASB ED proposes that the fair value of the investment at the date of the change in status shall be the investment's initial carrying amount.

6. The IASB ED proposes that an entity that becomes an investment entity accounts for the change in status prospectively by changing the accounting for its investments from the date the change in status occurred. The ED also proposes that the net impact of becoming an investment entity should be recorded as an adjustment to opening retained earnings in the reporting period of the change in status. The FASB ED proposes that the net impact of becoming an investment entity should be recorded as an adjustment to net assets at the date of the change in status.

Respondents' comments on the reassessment requirements proposed in the ED

7. Few respondents commented on this issue, although some respondents did express concern that the requirement to continuously reassess whether facts and circumstances are changing would be too onerous and stated that they preferred the 'purpose and design' approach proposed in the FASB ED.

8. Some respondents also stated that they would like more clarity in the guidance regarding a change in investment entity status. In particular, they noted that adjusting opening retained earnings is inconsistent with recognising the cumulative adjustment on the date of the change in status.

Staff analysis and recommendations

Basis for reassessment

9. The ED proposed that, in order to qualify as an investment entity, a number of criteria must be met, one of which is business purpose. At the May 2012 meeting, the boards decided to move away from a strict criteria-based assessment. Instead, the boards decided that an entity should consider its purpose and design when making the assessment of whether it is an investment entity. An entity would also be required to meet the definition of an investment entity and to consider specific factors in order to qualify to use the consolidation exception. This definition and the related factors to consider incorporate a wider range of facts than merely purpose and design.

10. The staff believe that restricting the reassessment of whether an entity is an investment entity only to situations in which the purpose and design of that entity changes may result in inappropriate accounting. This could lead to an entity continuing to avail itself of the consolidation exception in situations where it no longer meets the definition of an investment entity. Conversely, an entity that becomes an investment entity could mistakenly continue to consolidate its controlled investees. In both cases, the information provided to users of the financial statements would not reflect the information considered most relevant for those users.

11. The requirement to use facts and circumstances to both initially assess and subsequently reassess a particular situation is used in numerous IFRS standards and interpretations, including IFRS 10 *Consolidated Financial Statements*. We have not been made aware that the reassessment of facts and circumstances in other situations is considered unduly onerous for preparers or their auditors.

12. In addition, the staff do not expect a change in investment entity status to occur frequently and the cause of any change should be relatively simple to identify. Consequently, we do not believe that a requirement to reassess an investment entity's status based upon facts and circumstances would be onerous.

13. The staff recommend that an entity should reassess its investment entity status if facts and circumstances indicate that its status has changed.

Question 1: Reassessment of investment entity status
Does the IASB agree with the staff recommendation to require an entity to reassess its investment entity status if facts and circumstances indicate that its status has changed?

Accounting for a change of status as an investment entity

14. Although few respondents to the ED commented on whether a change in status should be accounted for prospectively, those that did comment agreed with the requirements of the ED to account for the change in status prospectively. However, some respondents were unclear as to the intentions of the IASB when setting out the more detailed requirements.

15. The following paragraphs are intended to clarify the IASB's intentions, so that the requirements can be more clearly drafted in the final requirements.

Loss of investment entity status

16. The IASB ED proposes that an entity that no longer meets the definition of an investment entity should account for the change in its status prospectively by changing the accounting for its investments from the date when the change in status occurred. This would require an entity, when that change in status occurs, to apply IFRS 3 *Business Combinations* to those investees that are required to be consolidated as a result of the entity no longer qualifying as an investment entity.

17. The staff believe that the intention of this guidance is to recognise the change in status as a significant economic event and to account for the change in status as a 'deemed acquisition', ie to use the fair value of the investment at the date of the

change of status of the investor as the 'deemed' consideration transferred. This effectively recognises the change in status in the same way as a business combination achieved in stages, as described in paragraphs 41-42 of IFRS 3 (as reproduced in Appendix A to this paper). This would result in the recognition of goodwill or a gain on a bargain purchase.

18. We therefore recommend that the final IFRS should include explicit guidance to reflect this intention.

Question 2: Accounting for loss of investment entity status
Does the IASB agree with the staff recommendation to provide more explicit guidance in the final investment entities amendments regarding the accounting for controlled investees in the case when an entity loses its investment entity status (that is, the requirements of IFRS 3 shall be applied and goodwill or a bargain purchase as applicable shall be recognised when an entity ceases to qualify as an investment entity)?

19. At its meeting in June 2012, the IASB confirmed the proposal in the ED that a non-investment entity parent should be required to consolidate all controlled investees, regardless of whether the investments are held through an investment entity subsidiary (ie an intermediate parent entity that qualifies as an investment entity). This decision raises an additional application issue when an investment entity subsidiary/intermediate parent ceases to qualify as an investment entity.

20. The intermediate parent will consolidate its controlled investees from the date of change in status if it loses investment entity status, in accordance with the requirements of IFRS 3. This will require the intermediate parent to identify the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, measured in accordance with IFRS 3 (which generally requires that these items should be measured at fair value on that date, with limited exceptions).

21. As a result, the assets and liabilities of these newly-consolidated investees will be recognised at different amounts in the consolidated financial statements of the intermediate parent from the amounts recognised in the consolidated financial statements of the higher-level parent. This will create additional costs for preparers.

22. However, if an intermediate parent ceases to qualify as an investment entity, there is already relief available within the scope of IFRS 10 for intermediate parents. IFRS 10 paragraph 4 gives an exemption from preparing consolidated financial statements to any intermediate parent that meets all of the following conditions:

    (a) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

    (b) its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

    (c) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

    (d) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs.

23. Consequently, we believe that the population of intermediate parent entities that would be affected by the additional costs of preparing consolidated financial statements using different amounts than those used by its higher-level parent because of a loss of status as an investment entity will be limited. In addition, we do not expect a change in investment entity status to occur frequently. We therefore do not recommend addressing this situation in the final IFRS.

Question 3: Accounting for loss of investment entity status by an intermediate parent
Does the IASB agree with the staff recommendation not to provide relief when an intermediate parent entity ceases to qualify as an investment entity?

Qualifying for investment entity status

24. The IASB ED requires an entity that becomes an investment entity to account for the change in its status prospectively by ceasing to consolidate its controlled investments from the date when the change in status occurred.

25. The staff believe that the intention of this guidance is to recognise the change in status as a significant economic event and to account for the change in status as a 'deemed disposal', ie to use the fair value of the investment at the date of the change of status of the investor as the consideration received for the purpose of applying the guidance in IFRS 10 (reproduced in Appendix B to this paper). This is consistent with the treatment set out for a loss of investment entity status.

26. Recognising the change in status to an investment entity as the exchange of an investment in a subsidiary for an investment measured at fair value will result in a gain or loss on the 'deemed disposal'. We have identified three alternatives for recognising this amount at the date of change in status:

    (a) Alternative 1: recognise it as a gain or loss in profit or loss, in accordance with the requirements of IFRS 10 for a loss of control. This reflects the change in the business purpose of the investor as a significant economic event, consistently with the rationale for gains and losses being recognised in profit or loss in IFRS 10 when control is lost. It is also consistent with the requirements of IFRS 9 (paragraph 5.6.2) relating to the accounting for the reclassification of a financial asset so that it is measured at fair value when an investor changes its business purpose.

    (b) Alternative 2: recognise it as a gain or loss in other comprehensive income. This would avoid a one-off gain or loss being recognised in profit or loss when an entity changes its status. If this alternative is selected, the IASB would then need to consider whether this gain or loss should be reclassified to profit or loss on disposal of the investment.

    (c) Alternative 3: recognise it as a gain or loss directly through the statement of changes in equity. This would also avoid recognising a one-off gain or loss when the entity changes its status. However, this would result in a portion of the change in value of the entity's investment in its controlled investees being permanently omitted from recognition through the statement of comprehensive income, and thus not being reflected in performance.

27. The staff recommend that an investor should account for the change of status of an investment entity by ceasing to consolidate its controlled investee and recognising the change in the same way as for a 'deemed disposal' by applying the guidance in IFRS 10, ie with the gain or loss being recognised in profit or loss (alternative 1).

Question 4: Accounting for qualifying for investment entity status
Does the IASB agree with the staff recommendation to provide explicit guidance in the final investment entities requirements regarding the accounting for when an entity becomes an investment entity (that is, the entity should apply the requirements of IFRS 10 for a deemed disposal and any resulting gain or loss shall be recognised in profit or loss (alternative 1))?

Disclosures

28. The ED proposes, in paragraph 10(a), that when an entity's status has changed, the entity shall disclose the change in status and reasons for the change. In addition, an entity that becomes an investment entity shall disclose the effect of the change in status on the financial statements for the period presented, including the effect of the change on the reported amounts of investments as of the date of the change in status and the related effects on profit or loss and total comprehensive income.

29. We recommend retaining this disclosure requirement in the final requirements.

Question 5: Disclosures on a change in investment entity status
When an entity changes its status, does the IASB agree with the staff recommendation to retain the proposed disclosures about a change in status?

Amendments to other IFRSs

30. The IASB have decided that, as well as accounting for controlled investees at fair value through profit or loss, an investment entity shall also measure its investments in associates and joint ventures in the same way. Consequently, amendments are needed to reflect this decision in IAS 28 *Investments in Associates and Joint Ventures* and IAS 27 *Separate Financial Statements*.

31. We recommend that consequential amendments be made to IAS 28 and IAS 27 that are consistent with the staff's recommendations for IFRS 10 reflected in questions 1-4 of this paper. This would provide a cohesive and consistent approach to accounting for a change in investment entity status for interests in subsidiaries, associates and joint ventures.

Question 6: Consequential amendments to IAS 28 and IAS 27
Does the IASB agree with the staff recommendations to draft reassessment guidance for amendments to IAS 28 *Interests in Associates and Joint ventures* and IAS 27 *Separate Financial Statements* that is consistent with the decisions made for the reassessment guidance for IFRS 10?

Appendix A

Summary of the requirements related to a business combination achieved in stages, as described in paragraphs 41-42 of IFRS 3 (see paragraph 17 of this paper)

Additional guidance for applying the acquisition method to particular types of business combinations

A business combination achieved in stages

41 An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on 31 December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 per cent interest in Entity B, which gives it control of Entity B. This IFRS refers to such a transaction as a business combination achieved in stages, sometimes also referred to as a step acquisition.

42 In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

Appendix B

Summary of the requirements related to a IFRS 10 relating to loss of control of a subsidiary, as described in paragraphs B98-B99 of IFRS 10 (see paragraph 25 of this paper)

B98 If a parent loses control of a subsidiary, it shall:

(a) derecognise:

(i) the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost; and

(ii) the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them).

(b) recognise:

(i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control;

(ii) if the transaction, event or circumstances that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution; and

(iii) any investment retained in the former subsidiary at its fair value at the date when control is lost.

(c) reclassify to profit or loss, or transfer directly to retained earnings if required by other IFRSs, the amounts recognised in other comprehensive income in relation to the subsidiary on the basis described in paragraph B99.

(d) recognise any resulting difference as a gain or loss in profit or loss attributable to the parent.

B99 If a parent loses control of a subsidiary, the parent shall account for all amounts previously recognised in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the parent shall reclassify the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses control of the subsidiary. If a revaluation surplus previously recognised in other comprehensive income would be transferred directly to retained earnings on the disposal of the asset, the parent shall transfer the revaluation surplus directly to retained earnings when it loses control of the subsidiary.