STAFF PAPER

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REG IASB Meeting

Project	**Investment Entities**
Paper topic	Sweep issues

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Introduction

1. In August 2012, the staff distributed a pre-ballot draft of *Investment Entities: Amendments to IFRS 10, IFRS 12, IAS 27 and IAS 28* ('the investment entities amendments') to the IASB and selected external reviewers.

2. As a result of comments received on the pre-ballot draft, we would like the IASB to discuss the following issues:

   (a) whether an investment entity should be required to have an exit strategy for substantially all of its investments;

   (b) the interaction between the fair value management requirement in IFRS 9 *Financial Instruments* and the fair value management component of the investment entity definition; and

   (c) whether an entity that provides investment-related services to external parties should qualify as an investment entity.

3. This paper:

   (a) summarises the issues raised in the review process;

   (b) provides a staff analysis of the issue; and

   (c) provides staff recommendations.

4. Appendix A of this paper provides the staff's recommendations for each of the three issues presented in this paper.

Exit strategy requirement

Draft requirements and feedback received

5. At the May 2012 board meeting, the IASB tentatively decided that an investment entity should have an exit strategy for substantially all of its investments. Consistent with this decision, paragraph B85G of the pre-ballot draft stated that:

   > A strategy to hold debt investments to maturity is not an exit strategy.

6. Some external reviewers were concerned that entities would be inappropriately disqualified from investment entity status because they have a substantial amount of debt investments that are held to maturity. They stated that in some jurisdictions, the majority of investment funds would not qualify as investment entities because they hold a substantial amount of debt investments to maturity. These reviewers offered a variety of reasons why an investment fund could hold debt investments to maturity:

   (a) Investment funds may make both debt and equity investments in their investees. The debt investments may have shorter maturities than the anticipated term of the fund's equity.

   (b) Investment funds may hold short-term debt investments to maturity to earn a return on funds temporarily while they identify suitable equity investment opportunities.

   (c) Investment funds may hold debt investments to diversify their portfolio and/or to mitigate risk to investors.

   (d) Investment funds may hold debt investments to manage liquidity risk and may hold those investments to maturity.

7. These reviewers stated that, in many cases, these debt investments would be measured at fair value through profit or loss following the requirements in IFRS 9 either because:

(a) they are managed on a fair value basis; or

(b) the entity has elected the fair value option in IFRS 9 to eliminate or significantly reduce an accounting mismatch, because, for example, it measures its financial liabilities on a fair value basis.

Staff analysis and recommendation

8. The staff originally recommended requiring an exit strategy, and thinks that the IASB accepted this recommendation and decided to require an exit strategy, for two reasons:

    (a) Holding investments for a limited period (that is, not holding investments indefinitely) is one of the key factors differentiating an investment entity from other entities. This is true particularly for equity investments in subsidiaries. Many operating companies or investment holding companies hold their subsidiaries indefinitely, but investment entities plan to hold all of their investments, including subsidiaries, for a limited period.

    (b) IFRS 9 requires that debt investments are held within a business model whose objective is to hold assets in order to collect contractual cash flows (and give rise to cash flows that are solely payments of principal and interest) should be measured at amortised cost. If an entity were required to hold its debt investments at amortised cost, it would not be appropriate that it should measure its subsidiaries at fair value.

9. The staff still think that an entity that holds its investments indefinitely should not qualify as an investment entity. However, the staff is concerned that an entity could be disqualified from investment entity status because it does not have an exit strategy for its debt investments even if it measures its debt investments at fair value through profit or loss using the requirements in IFRS 9 or IAS 39 *Financial Instruments: Recognition and Measurement*.

10. Consequently, the staff recommend changing the focus of the ‘exit strategy’ requirements. The staff recommend replacing the exit strategy requirement with a requirement that investment entities do not hold their investments indefinitely. This would mean that, typically, an investment entity would be required to have

an exit strategy for its equity investments and non-financial assets because these investments have the potential to be held indefinitely. An exit strategy for debt investments would not normally be required, because debt investments usually have a set maturity date and, therefore, cannot be held indefinitely.

11. Under this approach, entities that measure their investments at fair value through profit or loss would not be excluded from investment entity status merely because they do not have an exit strategy for some of their debt investments[1]. The staff think that, given that the primary focus of the investment entity project is to determine when it is appropriate to measure interests in a subsidiary at fair value, rather than to prescribe accounting for investment entities more broadly, the main focus for exit strategies should be on equity investments. In addition, one of the objectives of the project was to align the accounting for an investment entity's subsidiaries with the entity's other investments. In that case, the reason **why** an entity's debt investments are measured at fair value is not really important. IFRS 9 does not require an exit strategy in order to measure debt investments at fair value through profit or loss.

12. The staff do not think that changing the requirement for an exit strategy to a requirement that an investment entity should not hold investments indefinitely will weaken the guidance or lead to any additional concerns about structuring. The staff think that there is the greatest risk of an entity inappropriately qualifying as an investment entity when it holds equity investments (particularly equity investments that result in a controlling interest) indefinitely without a set exit strategy.

13. A debt instrument that is held to maturity will only generate investment income; it will not give the holder any capital appreciation. Consequently, the staff also recommend changing the definition of an investment entity in order to permit an investment entity to invest only for investment income (rather than requiring some element of capital appreciation). The staff note that this approach was proposed in the *Investment Entities* Exposure Draft and was generally supported; the IASB decided to change the definition in the May 2012 board meeting because of its

[1] This assumes those debt investments are measured at fair value. The 'fair value measurement' issue discussed in paragraphs 16-30 of this paper addresses whether an investment entity should be required to measure its investments at fair value using the requirements of existing IFRSs.

decision to require an exit strategy for substantially all of an investment entity's investments.

14. Moreover, some reviewers requested that we should provide definitions of 'investment income' and 'capital appreciation'. Some of those reviewers explained that they were concerned that the line between capital appreciation and investment income would become very important, because the pre-ballot draft prohibited an investment entity from investing only for investment income. The staff think removing the requirement that investment entities invest for capital appreciation from the definition should reduce the pressure on the dividing line between capital appreciation and investment income.

15. The staff's recommended wording is provided in Appendix A.

Question 1—exit strategy
Does the IASB agree with the staff recommendation to replace the requirement for an investment entity to have exit strategies for substantially all of its investments with a requirement that an investment entity should not hold any of its investments indefinitely?

Fair value management

Draft requirements and feedback received

16. The pre-ballot draft required an investment entity to manage and evaluate the performance of substantially all of its investments on a fair value basis, consistent with the decisions made at the May 2012 board meeting.

17. Some reviewers questioned this requirement and its interaction with the guidance in IFRS 9. In particular, some asked whether the fair value management requirement in the amendments is different from the fair value management guidance in IFRS 9 and noted that:

    (a) The amendments require an entity to consider its relationship with its investors when determining if it manages on a fair value basis (eg, whether investors prioritise fair value information or transact with the investment entity on a fair value basis). However, the relationship between the entity and its investors is not explicitly considered in the guidance in IFRS 9.

(b) The unit of account in IFRS 9 for determining whether an entity is managing its investments on a fair value basis is typically at a level lower than the reporting entity. The unit of account in the pre-ballot draft was unclear. However, the draft implied that the 'fair value management' requirement should be applied at an entity level.

Staff analysis and recommendation

18. The staff agree that the interaction between the fair value management guidance in IFRS 9 and the investment entities pre-ballot draft is potentially confusing. On reflection, the staff do not think that there needs to be such a close link with IFRS 9, nor should there be—investment entities may not yet be applying IFRS 9, and IFRS 9 does not assess fair value management at an entity level. Consequently, the staff recommend that the 'fair value management' component of the investment entity definition should be **reworded** to avoid such a close link with the fair value management guidance in IFRS 9.

Fair value measurement and performance evaluation

19. The staff recommend that the definition of an investment entity should instead require that to be an investment entity, an entity must measure and evaluate the performance of substantially all of its investments on a fair value basis. This would require that an investment entity should measure substantially all of its assets at fair value using the guidance in existing IFRSs. For example, an investment entity would elect the fair value model in IAS 40 *Investment Properties* and would measure all of its financial assets at fair value using the requirements in IFRS 9 (or IAS 39 as applicable).

20. However, the staff recommend that the definition should also continue to require an entity to evaluate its performance on a fair value basis and that the application guidance should retain the focus on fair value as the primary measure of an investment entity's performance. The relevance of fair value information is the basis of the project and of the proposed exception to consolidation, and the staff think that it is important to retain that emphasis.

21. The staff think that changing the focus from 'fair value management' to 'fair value measurement', while still requiring performance evaluation on a fair value basis, will avoid any confusion with the fair value management guidance in IFRS 9. This approach will also allow an entity to consider its relationship with its investors when determining if it is an investment entity (eg if the entity's investors focus on fair value information or interact with the investment entity on a fair value basis) and will allow an entity-wide assessment of fair value measurement and performance.

IAS 28 guidance

22. If the IASB accepts the staff's recommendation to change the fair value management requirement, the staff also recommend changing the interaction between the investment entity requirements and IAS 28 *Investments in Associates and Joint Ventures*.

23. The pre-ballot draft required investment entities to measure their interests in associates and joint ventures at fair value through profit or loss. The staff now recommend retaining the existing option in IAS 28 for venture capital organisations, mutual funds, unit trusts and similar entities. The staff also recommend including application guidance in the investment entities amendments stating that in order to meet the 'fair value measurement' component of the investment entity definition, an entity would have to elect the fair value option in IAS 28.

24. The staff think that this will achieve the same accounting outcome as having an explicit fair value requirement for investment entities in IAS 28 would have done, but will be simpler. In order to meet the definition of an investment entity, an entity would need to elect the existing option in IAS 28. Consequently, a separate fair value requirement for investment entities' interests in associates and joint ventures is not needed in IAS 28. Relying on the existing guidance in IAS 28 would also be consistent with the staff's proposed focus on using existing guidance in IFRSs for fair value measurement in the definition of an investment entity. Just as an entity would have to elect to use the fair value model under IAS 40 and would have to measure its financial assets at fair value under IFRS 9 or IAS 39 in order to meet the definition of an investment entity, an entity should

also be required to elect the FV option in IAS 28 in order to meet the definition of an investment entity. The staff also note that, under this new approach, the investment entities project could truly be described as only providing an exception from consolidation.

25. The staff note that this could be viewed as making investment entity status 'optional'. An entity could avoid meeting the definition of an investment entity by not electing the fair value option in IAS 28. However, the staff note that such a possibility already exists in the pre-ballot draft. An entity could avoid meeting the definition of an investment entity by not choosing the fair value model in IAS 40. Moreover, the staff note that they would not expect entities whose investors demand fair value information to try to avoid qualifying as investment entities as, presumably, there would be a negative market reaction.

26. The staff also note that their recommended approach would also conflict with the IASB's previous tentative decision to require an investment entity to use the equity method for its interests in associates or joint ventures that provide services to the investment entity. The staff note that, under their proposed approach, an entity would be required to measure all of its investments in associates and joint ventures at fair value to qualify as an investment entity, even its investments in service-providing associates or joint ventures. However, the staff are not overly concerned with this as they do not think investment entities will typically have service-providing associates or joint ventures

FVOCI

27. The staff also recommend that the investment entities amendments include some language clarifying that, in accordance with IFRS 9 and IAS 39, some assets may be measured at fair value with fair value changes recognised in Other Comprehensive Income rather than in Profit and Loss and that this measurement would be considered fair value measurement for the purposes of the definition of an investment entity. The staff recommend that this language should be included in the Basis for Conclusions. The staff also note that this is consistent with the conclusions reached at the July 2012 board meeting.

28. The staff think that an investment entity could potentially measure financial assets at FVOCI for three reasons:

(a) by holding available-for-sale investments under IAS 39;

(b) by electing the irrevocable fair value option for equity instruments in IFRS 9 (which is available to all equity instruments except those held for trading); or

(c) by holding financial instruments that qualify for the FVOCI category in the limited amendments to IFRS 9 that the IASB is currently considering.

29. Again, the staff do not think that many investment entities will measure their financial assets at FVOCI, especially under the current requirements in IFRS 9, but acknowledges that there is a possibility that they could do so. The staff do not think that measuring financial assets at FVOCI should disqualify an entity from investment entity status.

30. Consequently, the staff recommend that the changes proposed in Appendix A should be made to the ‘fair value management’ component of the investment entity definition that was proposed in the pre-ballot draft. The staff note that they do not see this as a substantive change to the investment entities requirements but rather as a clarification.

Question 2—fair value measurement

Does the IASB agree with the staff recommendations that:

a) the ‘fair value management’ component of the definition should be changed to require an investment entity to measure substantially all of its investments at fair value;

b) the proposed requirement in IAS 28 that an investment entity should measure its investments in associates and joint ventures at fair value through profit or loss should be removed and that the current option in IAS 28 should be retained, with the addition of ‘investment entities’ in the list of entities eligible for the fair value option; and

c) the should be an addition to the Basis for Conclusions of language stating that an investment entity can measure financial assets at FVOCI and still meet the ‘fair value measurement’ component of the investment entity definition.

Investment-related services

Draft requirements and feedback received

31. The pre-ballot draft proposed that an entity could qualify as an investment entity even if it provided:

    (a) substantive investment-related services if those services were provided only within the investment entity; and

    (b) investment-related services to third parties only if those services were not substantive.

32. The pre-ballot draft also proposed that an investment entity should consolidate service-providing subsidiaries if those subsidiaries only provided services to the investment entity.

33. Some reviewers disagreed with the requirement described in paragraph 31(b) and instead requested that the IASB should allow an entity to qualify as an investment entity even if it provides investment-related services to third parties, regardless of whether those services were substantive or not. These reviewers noted that many private equity companies, particularly listed private equity companies, provide significant investment management services to third parties and would be disqualified under the guidance in the pre-ballot draft. However, these entities' business model is still focused on investing, and investors demand fair value information for the investments held by these entities. Reviewers requested that these companies should qualify as investment entities but that they should be required to consolidate any subsidiary that was providing investment-related services.

Staff analysis and recommendation

34. The staff do have sympathy with the issue raised by reviewers and is concerned that the IASB's previous tentative decision will exclude a number of private equity companies who the staff think should qualify as investment entities. The

staff note that a number of the private equity companies that provide substantive investment-related services are listed companies in Europe who are required to follow IFRSs. The staff also note that discussions with users have confirmed that they view fair value information as equally important for private equity companies, regardless of whether an entity provides investment-related services to third parties.

35. The staff agree with the reviewers' and users' arguments and therefore recommends that an entity should not be disqualified from investment entity status only because it provides substantive investment-related services, either internally or to third parties. The staff think that the provision of such services is within the business model of an investment entity; although the subsidiaries providing these services should themselves be consolidated, their presence does not change the business purpose of the entity so that fair value is no longer the most relevant information for the entity's investments. Although such an entity may earn fee income from its provision of investment-related services, its sole business purpose is still investing (whether that is for itself or for external parties).

36. The recommended wording is included in Appendix A.

Question 3—investment-related services
Does the IASB agree with the staff recommendation that an entity should not be disqualified from investment entity status only because it provides substantive investment-related services to third parties?

Appendix A

The following provides the staff's recommended wording for the following areas:

a) *Exit strategy (discussed in paragraphs 5-15 of the agenda paper)*

b) *Fair value measurement (discussed in paragraphs 16-30 of the agenda paper)*

c) *Investment-related services (discussed in paragraphs 31-36 of the agenda paper)*

Exit strategy

27 An investment entity is an entity that:

(a) …

(b) commits to its investor(s) that its business purpose and only substantial activities are investing funds for returns from capital appreciation, investment income or both; and

(c) …

Exit strategy

B85F An entity's business purpose is also evidenced through its investment plans. One feature that differentiates an investment entity from other entities is that an investment entity does not plan to hold its investments indefinitely; it holds them for a limited period of time. Accordingly, an investment entity shall have an exit strategy documenting how the entity plans to realise capital appreciation of its equity investments and non-financial asset investments, because these investments have the potential to be held indefinitely. The exit strategy need not document specific exit strategies for each individual equity investment but shall identify different potential strategies for different types or portfolios of equity investments, including a substantive timeframe for exiting those investments. Exit mechanisms that are merely put in place for default events, such as breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.

B85G Exit strategies can vary by type of equity investment. For investments in private equity securities, examples of exit strategies include an initial public offering, a private placement, a trade sale of a business, distributions (to investors) of ownership interests in investees and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee). For equity investments traded in a public market, examples of exit strategies include selling the investment in a private placement or in a public market.

B85H An investment entity would be required to have an exit strategy only for debt investments that do not have a set maturity date, so that the investment entity does not have the possibility of holding them indefinitely without an exit strategy.

Exit strategy

BC245 The IASB believes that a parent with operating subsidiaries often plans to own and operate its subsidiaries indefinitely to realise returns from those operations. However, the IASB does not think that an investment entity should hold its investments, especially its investments in subsidiaries, indefinitely.

BC246 Accordingly, the IASB considered requiring an exit strategy for substantially all investments held by an investment entity, including debt investments. However, the IASB noted that some investment funds that would otherwise qualify as investment entities may hold a significant amount of debt investments to maturity and therefore would not have an exit strategy for those debt investments.

BC247 For example, the IASB understands that in some cases, private equity funds may make debt and equity investments in their investees. The debt investments may have shorter maturities than the anticipated term of the fund's equity investment and may be held to maturity. Moreover, an investment entity may hold debt instruments to maturity to manage liquidity risk or to mitigate the risk from holding other types of more volatile investments. Although the entity does not have an exit strategy for these debt investments, it does not plan to hold them indefinitely—even if the entity does not plan to sell these investments before maturity, the vast majority of debt investments have a limited life. The IASB decided that such an entity should not be prohibited from qualifying as an investment entity, provided that substantially all of its investments (including debt investments) are measured at fair value. Debt investments may be measured at fair value in accordance with IFRS 9 even in the absence of an exit strategy.

BC248 However, the IASB decided that an investment entity must have an exit strategy for all of its investments that can be held indefinitely (typically equity investments and non-financial assets). The IASB does not think it is appropriate for an entity to qualify for an exception from consolidation if that entity is holding equity investments indefinitely and not planning to realise capital appreciation from those investments. Although the exit strategy may vary depending on the nature and objectives of the investment, on the development of the investee, or on market conditions or other circumstances, potential exit strategies that include a substantive time frame for exiting the investment should still be identified and documented for equity investments in order to meet the definition of an investment entity.

Fair value measurement

27 An investment entity is an entity that:

(a) …

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

Fair value measurement

B85I For an investment entity, measuring substantially all of its investments at fair value results in more relevant information than, for example, consolidating its subsidiaries or using the equity method for its interests in associates or joint ventures. Accordingly, an investment entity is required to measure and evaluate the performance of substantially all of its investments on a fair value basis. In order to meet this requirement an investment entity must:

a) measure substantially all of its investments at fair value in its financial statements prepared in accordance with IFRSs. In determining whether it meets this requirement, the entity shall exclude interests in subsidiaries that would be accounted for in accordance with this Standard if the entity were not an investment entity.

b) demonstrate that fair value is the primary measurement attribute used, both internally and externally to evaluate the performance of substantially all of its investments and to make investment decisions about those assets. In order to demonstrate this, fair value information must be used internally by the entity's key management personnel and be provided to the entity's investors.

B85J In order to meet the requirement in B85I, an entity would account for any investments in investment property using the fair value model in IAS 40, would elect the exception from the equity method in IAS 28 for its interests in associates and joint ventures, and would measure its financial assets at fair value in the statement of financial position using the requirements in IFRS 9.

B85K An investment entity may have some non-investment assets, such as a head office property and related equipment (which will be accounted for in accordance with IAS 16 *Property, Plant and Equipment*) and may also have financial liabilities (which will be accounted for in accordance with IFRS 9). Paragraph 27(c) of the definition of an investment entity applies to an entity's investments. Accordingly, an investment entity need not measure its non-investment assets or its financial liabilities at fair value.

Fair value measurement

BC249 In the development of IFRS 10 and the *Investment Entities* ED, the IASB heard that fair value information is the primary driver of the decision-making processes of both management of the investment entity and investors in the investment entity. Feedback to the *Investment Entities* ED confirmed this. Many respondents stated that both management and investors evaluate the performance of an investment entity by reference to the fair value of its investments. The IASB heard that some investors in investment entities disregard the consolidated financial statements of investment entities and instead rely on non-GAAP fair value reports.

BC250 The basis for the exception from consolidation provided to investment entities is that fair value information is the most relevant information for an investment entity's investments, including its investments in subsidiaries. The IASB therefore decided that to meet the definition of an investment entity, an entity should measure and evaluate substantially all of its investments on a fair value basis.

BC251 As part of this requirement, an investment entity should measure substantially all of its investments at fair value in its financial statements prepared in accordance with IFRSs (excluding any interests in subsidiaries that would otherwise be accounted for using the consolidation requirements in IFRS 10). The IASB does not think that an entity who fails to elect the fair value measurement option available in IAS 28 or IAS 40 or that accounts for its financial assets at amortised cost under IFRS 9, should qualify as an investment entity. Correspondingly, the IASB decided that an essential feature of the definition of an investment entity is that the investment entity would use existing IFRS requirements or accounting policy options to measure substantially all of its investments at fair value. For financial assets the IASB noted that, in accordance with IFRS 9 and IAS 39, some assets may be measured at fair value on the statement of financial position with fair value changes recognised in Other Comprehensive Income rather than in Profit and Loss and agreed that this measurement would be considered fair value measurement for the purposes of the definition of an investment entity.

BC252 The IASB also decided that, in order to meet the requirement described in paragraph BC250, an entity should demonstrate that fair value is the primary measurement attribute used to evaluate the performance of its investments, both internally and externally. The IASB thinks that fair value should be the primary measurement attribute used by an investment entity's key management personnel to assess the entity's performance and to make investing decisions. The IASB also thinks that a key distinguishing characteristic of an investment entity is that investors in an investment entity are primarily interested in fair value and make their investing decisions based on the fair value of the investment entity's underlying investments. The IASB notes that this is partly because, in many cases, investors in an investment entity transact with the investment entity on a fair value basis (for example, on the basis of a net asset value per share, which is calculated using the fair value of the entity's underlying investments).

Investment-related services

B85D Notwithstanding the requirement in paragraph 31, if an investment entity has a subsidiary that provides investment-related services (see paragraph B85E), the investment entity shall consolidate that subsidiary in accordance with paragraphs 19-26 of this IFRS and the related application guidance in paragraphs B86-B99 and shall apply the requirements of IFRS 3 to the acquisition of any such subsidiary.

B85E An investment entity may have a subsidiary that provides services that relate to the investment entity's investment activities (eg investment management services, investment advisory services, administrative support, a treasury or finance function), even if those activities are substantial or are provided to third parties in addition to the investment entity. If an investment entity has such a subsidiary, the investment entity shall consolidate that subsidiary in accordance with paragraph 32.