

STAFF PAPER

March 2014

IASB Meeting

IFRS IC Nov 2013 and Jan 2014

Project	Narrow-scope amendments to IFRS 10 <i>Consolidated Financial Statements</i>
Paper topic	Investment Entities Amendments—an investment entity subsidiary that also provides investment-related services
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Introduction

1. In November 2013 and January 2014, the IFRS Interpretations Committee (the ‘Interpretations Committee’) discussed a request to clarify the accounting by an investment entity that has an investment entity subsidiary (which has investees measured at fair value) and, additionally, provides investment-related services or activities.
2. According to the submitter, in the case in which an investment entity subsidiary meets the definition of an investment entity and, additionally, provides investment-related services or activities, it is unclear whether the investment entity parent should measure that subsidiary at fair value or consolidate it.
3. The Interpretations Committee tentatively concluded that an investment entity parent should account for all investment entity subsidiaries at fair value and recommended that IFRS 10 *Consolidated Financial Statements* should be amended to make this clearer.

Purpose of this paper

4. The objective of this paper is to:
 - (a) present background information on the issue; and

- (b) provide a summary of the Interpretation Committee's rationale for recommending that the IASB should amend IFRS 10.

Background information

5. An investment entity shall measure its investments in a subsidiary at fair value, in accordance with paragraph 31 of IFRS 10:

31 Except as described in paragraph 32, an investment entity shall not consolidate its subsidiaries or apply IFRS 3 when it obtains control of another entity. Instead, an investment entity shall measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9.

6. If a subsidiary provides services that relate to the investment entity's investment activities, the investment entity shall consolidate the subsidiary, in accordance with paragraph 32 of IFRS 10:

32 Notwithstanding the requirement in paragraph 31, if an investment entity has a subsidiary that provides services that relate to the investment entity's investment activities (see paragraphs B85C–B85E), it shall consolidate that subsidiary in accordance with paragraphs 19–26 of this IFRS and apply the requirements of IFRS 3 to the acquisition of any such subsidiary.

7. The Interpretations Committee received a request to clarify how an investment entity should account for a subsidiary that is itself an investment entity, but that also provides investment-related services. According to the submitter, in the case in which an investment entity subsidiary meets the definition of an investment entity (which has investees measured at fair value) and, additionally, provides investment-related services or activities, it is unclear whether the investment entity parent should measure that subsidiary at fair value or consolidate it. In addition, if it does consolidate, it is not clear how the investment entity parent accounts for investees; should the parent consolidate the investment portfolio on a

line-by-line basis, or should the parent measure the entire portfolio and any third-party debt held at fair value.

8. The Interpretations Committee observed that IFRS 10 was clear that:
 - (a) an investment entity parent should account for a subsidiary that is also an investment entity at fair value if that subsidiary does not provide investment-related services (see paragraph 31 of IFRS 10); and
 - (b) an investment entity parent should consolidate on a line-by-line basis a subsidiary that is not an investment entity, but that provides investment-related services, because such services are an extension of the operations of the investment entity parent (see paragraph 32 of IFRS 10).

9. However, the Interpretations Committee noted that it is not clear how to account for a subsidiary that is both an investment entity subsidiary and that provides investment-related services. Accordingly, the Interpretations Committee decided to add this issue to its agenda and observed that analysing this issue requires clarity about what services are provided, and to whom, in order for these services to qualify as investment-related services.

Summary of the staff analysis

Consideration of types of investment-related services and activities and to whom delivered

10. Paragraphs B85C–B85D of IFRS 10 provide descriptions of investment-related services and activities as follows:

B85C An investment entity may provide investment-related services (eg investment advisory services, investment management, investment support and administrative services), either directly or through a subsidiary, to third parties as well as to its investors, even if those activities are substantial to the entity.

B85D An investment entity may also participate in the following investment-related activities, either directly or through a subsidiary, if these activities are undertaken to maximise the investment return (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity:

- (a) providing management services and strategic advice to an investee; and
- (b) providing financial support to an investee, such as a loan, capital commitment or guarantee.

11. We analysed the nature of the services, and to whom the services are provided, for investment-related services and activities as described in paragraphs B85C–B85D of IFRS 10 as follows:

	Nature of services	To whom
Investment-related services (paragraph B85C)	(examples) <ul style="list-style-type: none"> • investment advisory services; • investment management; • investment support; and • administrative services. 	<ul style="list-style-type: none"> • to third parties • to its investors
Investment-related activities (paragraph B85D)	(if these activities are undertaken to maximise the investment return from its investees) <ul style="list-style-type: none"> • management services; • strategic advice; and • financial support. 	<ul style="list-style-type: none"> • to its investees

12. We note that the provision of these services does not preclude an entity from qualifying as an investment entity. Consequently, the services may be provided either by the investment entity or by an operating subsidiary that supports the investment entity (and other group entities).

13. In preparing this analysis, we think that it is helpful to go through the IASB’s deliberations in chronological order.

Summary of the IASB's discussions in the light of an analysis of the types and recipients of investment-related services and activities that relate only to the entity's own investment activities

14. The *Investment Entities* Exposure Draft, issued in August 2011, proposed that, if an investment entity controls an investee that provides services that relate only to the entity's own investment activities, it shall consolidate that investee.
15. In redeliberations, the IASB decided to retain these proposals in the final Standard. The decision to require consolidation of an investee that provides services that relate only to the entity's own investment activities is explained in paragraph BC240 of IFRS 10 (emphasis added):

BC240 The Board noted that an investment entity may sometimes hold an interest in a subsidiary that provides investment-related services for its investment activities. The Board did not think that the existence of such a subsidiary should prohibit an entity from qualifying as an investment entity, even if those services were substantial or were provided to third parties¹ in addition to the entity. **The Board views such services as an extension of the operations of the investment entity and therefore concluded that subsidiaries that provide those services should be consolidated.**

16. During these redeliberations in June 2012, an entity providing substantive investment-related services to third parties would have been classified as an operating entity, instead of an investment entity. However, in September 2012, the IASB made a decision to allow the definition of an investment entity to include the provision of investment-related services to third parties.

¹ The provision of investment-related services to third parties was subsequently allowed in September 2012.

An investment entity parent's accounting for an investment entity subsidiary (June 2012 meeting)

17. In its June 2012 meeting, the IASB tentatively decided that an investment entity should be required to measure, without exception, all controlling interests in another investment entity at fair value, rather than consolidating those subsidiaries.
18. With regard to this decision, paragraph BC272 of IFRS 10 states:

BC272 The Investment Entities ED proposed that an investment entity would measure all of its subsidiaries at fair value (except for those subsidiaries providing investment-related services), even those investees who were themselves investment entities. Some respondents questioned this proposal and suggested that at least some investment entity subsidiaries should be consolidated (for example, wholly-owned investment entity subsidiaries that are created for legal, tax or regulatory purposes). However, the Board thinks that fair value measurement of all an investment entity's subsidiaries (except for those subsidiaries providing investment-related services or activities) would provide the most useful information and therefore decided to retain this proposal. The Board considered requiring an investment entity to consolidate only those investment entity subsidiaries that are formed for legal, tax or regulatory purposes, but decided against this because there is no conceptual basis for distinguishing between different investment entity subsidiaries. Moreover, the Board thinks that it would be very difficult to distinguish between an investment entity subsidiary formed for a specific legal, tax or

regulatory purpose and those that are set up only for other business reasons.

Investment-related services to third parties (September 2012 meeting)

19. In its September 2012 meeting, the IASB decided to allow an entity to qualify as an investment entity even if it provided significant investment-related services to third parties. We noted that the IASB considered that the investment-related services provided to third parties are simply an extension of the investment entity's activities. Paragraph BC239 of IFRS 10 states (emphasis added):

BC239 The *Investment Entities* ED did not allow an entity to qualify as an investment entity if it provided substantive investment-related services to third parties. While some respondents agreed with this, others argued that an investment entity should be allowed to provide such services to third parties. **They argued that the provision of these investment-related services to third parties is simply an extension of the investment entity's investing activities and should not prohibit an entity from qualifying as an investment entity.** The Board agreed with these arguments, concluding that the provision of such services is within the business model of an investment entity. Although such an entity may earn fee income from the provision of investment-related services, its sole business purpose is still investing for capital appreciation, investment income, or both (whether that is for itself, for its investors or for external parties).

Conclusions on the analysis of types and recipients of investment-related services and activities

20. We think that the IASB’s decisions to require fair value measurement of all investment entity subsidiaries and the consolidation of non-investment-entity (operating) subsidiaries that provide investment-related services **within** the group and to investors/investees are clear. We therefore conclude from the IASB’s discussion that an investment entity subsidiary that also provides investment-related services to its investors and investment-related activities to its investees should be accounted for at fair value. We note that these services and activities are common services and activities that most investment entities will be engaged in. We also note that the IASB did not make any exceptions to these requirements.
21. However, we noted that the accounting for an investment entity subsidiary that provides investment-related services to third parties was not explicitly discussed, because the IASB did not agree to allow an entity to provide those services and meet the definition of an investment entity until the later meeting (September 2012).
22. We summarise our analysis as follows:

	To whom	Subsidiary that provides service is an investment entity	Subsidiary that provides service is not an investment entity (operating subsidiary)
Investment-related services (paragraph B85C)	• to third parties	Not discussed	Consolidation
	• to its investors	No consolidation (fair value accounting)	
Investment-related activities (paragraph B85D)	• to its investees		

23. Consequently, the Interpretations Committee focused on the intended accounting treatment for an investment entity subsidiary that is itself an investment entity and that also provides investment-related services to third-parties.

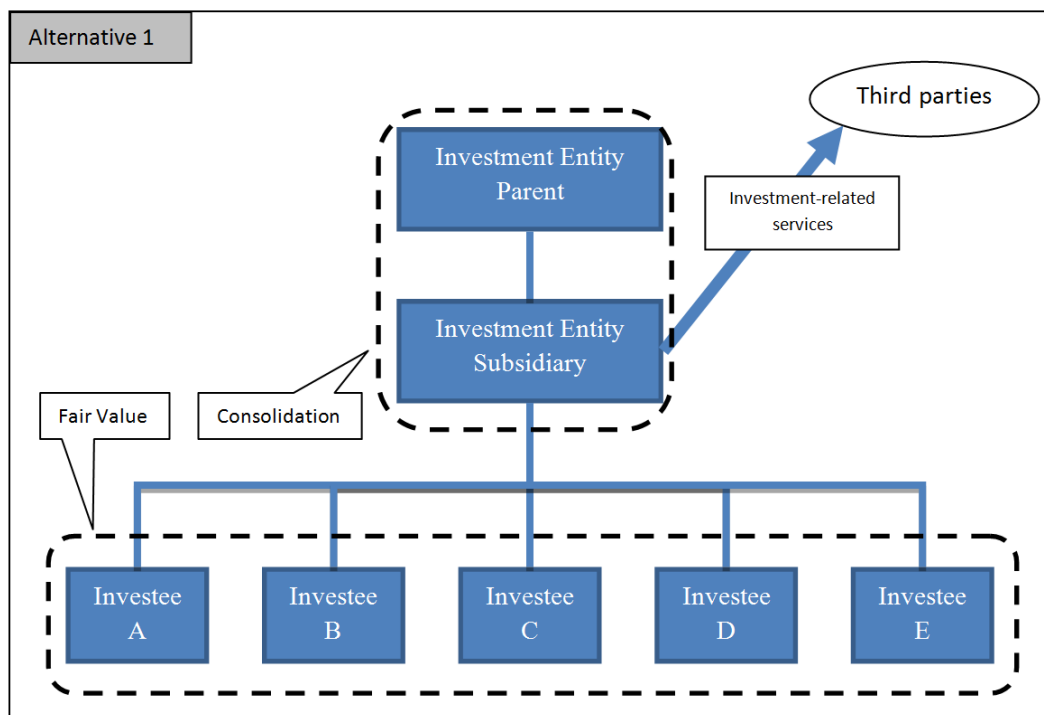
Alternatives for accounting for an investment entity subsidiary that provides investment-related services to third parties

24. The Interpretations Committee analysed two alternative approaches to how an investment entity parent should account for an investment entity subsidiary that provides investment-related services to third parties as follows:

Alternative 1: require an investment entity parent to consolidate an investment entity subsidiary that provides investment-related services to third parties. In addition, require fair value measurement for its portfolio of investments.

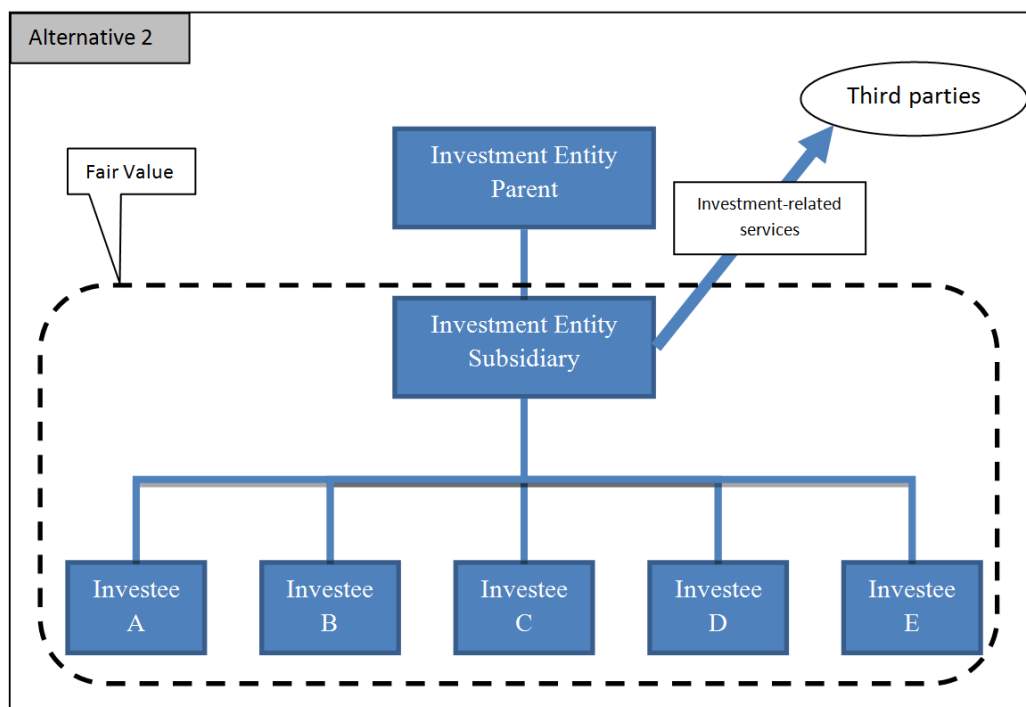
Alternative 2: require an investment entity parent to measure an investment entity subsidiary at fair value, even if the investment entity subsidiary provides investment-related services to third parties. This would be the same accounting as is required for an investment entity subsidiary that provides investment-related services to its investors and investees (see paragraph 19).

Alternative 1: require an investment entity parent to consolidate an investment entity subsidiary that provides investment-related services to third parties. In addition, require fair value measurement for its portfolio of investments.



- 25. Alternative 1 would require an investment entity parent to consolidate an investment entity subsidiary that provides investment-related services to third parties.
- 26. We think that these consolidated financial statements could provide some useful information to users. The consolidated statement of financial position would show the fair value of the portfolio of investments, while other assets and liabilities that are held by the investment entity subsidiary would be consolidated. In addition, investment-related services revenues from third parties and expenses incurred by the investment entity subsidiary are presented in the income statement.

Alternative 2: require an investment entity parent to measure an investment entity subsidiary at fair value, even if the investment entity subsidiary provides investment-related services to third parties



- 27. Alternative 2 would require an investment entity parent to measure an investment entity subsidiary at fair value, even if the investment entity subsidiary provides investment-related services to third parties. As a result, the investment entity subsidiary would be measured at fair value, which would include the fair value of

the portfolio of the investee, and be presented as a single line item on the financial statement of investment entity parent.

28. We noted that this alternative is consistent with the decision made in the June 2012 IASB meeting for investment entities' subsidiaries, including those that provide investment-related services to their investors and investment-related activities to their investees.

Information about prevalence

29. As a result of the outreach conducted before the finalisation of the amendments in *Investment Entities* in 2012, stakeholders noted that an investment entity subsidiary that provides investment-related services to third parties is typically an operating subsidiary that is not itself an investment entity and does not hold a portfolio of investees.

The Interpretations Committee's view

Guidance on accounting for an investment entity subsidiary that also provides investment-related services to third parties

30. At the January 2014 meeting, the Interpretations Committee members observed that while they acknowledge that there are valid arguments for Alternative 1, they preferred Alternative 2 because they think that:
- (a) the IASB's decision was clear that an investment entity parent should account for an investment entity subsidiary at fair value even when that investment entity subsidiary provides investment-related services to its investors or when it carries out investment-related activities in relation to its investees. If it is rare in practice that a subsidiary would qualify as an investment entity and provide investment-related service to third parties, specific guidance addressing the case in which the investment entity subsidiary provides investment-related services to third parties would not be necessary.
 - (b) Alternative 2 is more straightforward and is consistent with the IASB's previous decision not to create an exception to the fair value accounting requirements for all subsidiaries that are themselves investment entities.

Interpretations Committee conclusion and staff recommendation

31. The Interpretations Committee has concluded that all investment entity subsidiaries should be accounted for at fair value. However, the Interpretations Committee thought that the wording in the Standard is not sufficiently clear to achieve this outcome. Consequently, the Interpretations Committee proposed that this accounting should be made clear through Annual Improvements.
32. The staff agree with the Interpretations Committee proposals to clarify the wording in IFRS 10 in accordance with the conclusion in paragraph 29. However, because this issue is urgent and we are proposing narrow-scope amendments related to other issues in *Investment Entities* in Agenda Papers 12C and 12D, we propose that this issue should also be combined with those suggested narrow-scope amendments to IFRS 10 and IAS 28, instead of being dealt with through Annual Improvements.

Questions for the IASB

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Does the IASB agree with the Interpretations Committee's analysis and recommendation to amend IFRS 10?