

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—exemption from preparing consolidated financial statements requirements in IFRS 10: Applicability to a subsidiary of an investment entity
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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 interaction between the investment entity amendments and the exemption from preparing consolidated financial statements requirements in IFRS 10 *Consolidated Financial Statements*.
2. The issue is whether the exemption set out in paragraph 4(a) of IFRS 10 is available to entities that, as a result of the amendments in *Investment Entities*, are measured at fair value in the consolidated financial statements of the parent entity.
3. The Interpretations Committee discussed this issue in its November 2013 and January 2014 meetings, but it did not reach a consensus. Consequently, the Interpretations Committee asked the staff to consult the IASB on this issue. As a result of the staff’s feedback to the IASB in its last meeting, the IASB asked the staff to bring papers on this and other issues related to the amendments in *Investment Entities* to the March IASB meeting because of the need to clarify these issues quickly for implementation this year.

Purpose of this paper

4. The objective of this paper is to:

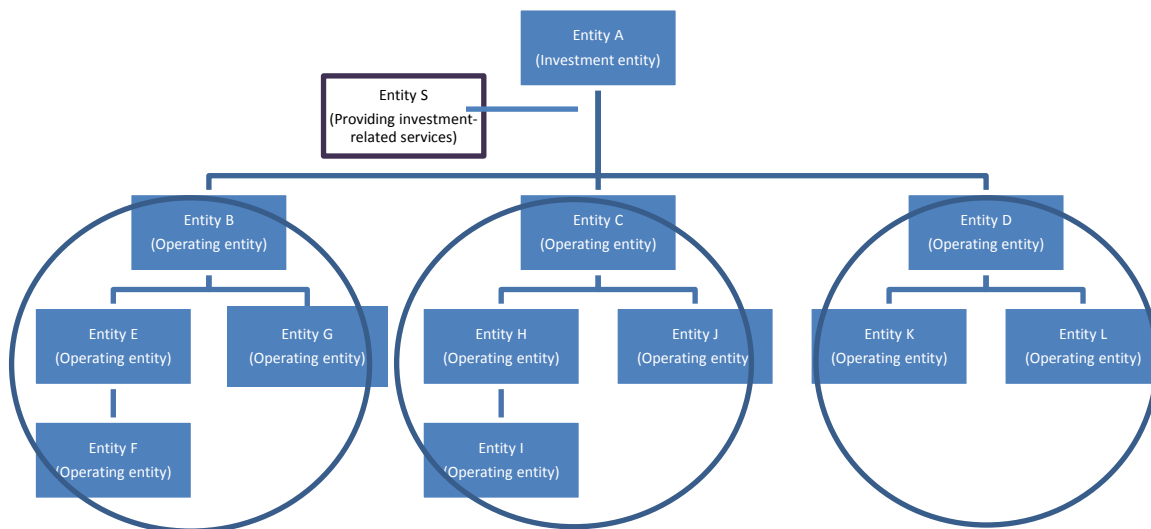
- (a) present background information on the issue;
- (b) provide a summary of the Interpretation Committee's discussions; and
- (c) set out the staff's rationale for recommending that the IASB should amend IFRS 10.

Background information

5. IFRS 10 requires a parent entity to present consolidated financial statements. However, paragraph 4 of IFRS 10 provides an exemption whereby a parent need not present consolidated financial statements if the entity meets the criteria in paragraph 4(a) of IFRS 10. This exemption has been long established in IFRS, having been carried forward into IFRS 10 from IAS 27 *Consolidated and Separate Financial Statements*.
6. Paragraph 4 of IFRS 10 states the exemption for presenting consolidated financial statements as follows:
 - 4 An entity that is a parent shall present consolidated financial statements. This IFRS applies to all entities, except as follows:
 - (a) a parent need not present consolidated financial statements if it meets all the following conditions:
 - (i) 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;
 - (ii) 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);

- (iii) 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
 - (iv) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs.
- (b) post-employment benefit plans or other long-term employee benefit plans to which IAS 19 Employee Benefits applies.
 - (c) an investment entity need not present consolidated financial statements if it is required, in accordance with paragraph 31 of this IFRS, to measure all of its subsidiaries at fair value through profit or loss.

7. The issue presented to the Interpretations Committee is whether intermediate parents (Entities B, C and D in the following diagram) can use the exemption from preparing consolidated financial statements in accordance with paragraph 4(a) of IFRS 10, if the intermediate parents (Entities B, C and D) are included at fair value in its investment entity parent's (Entity A) financial statements. In the following case, Entity A presents consolidated financial statements, but it only consolidates its investment-related service (Entity S) and measures all other subsidiaries at fair value.



8. The supplementary issue is whether the answer should change if the investment entity (Entity A) does not have an investment-related service subsidiary (Entity S) to consolidate. In that case, Entity A need not present consolidated financial statements but instead only presents separate financial statements. In those separate financial statements it will measure its portfolio of investments at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*.

Staff analysis of the issue

9. We considered the wording of the criteria in paragraph 4 of IFRS 10. One of the criteria (paragraph 4(a)(iv)) is ‘its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs’.
10. This criterion does not specify how the results of subsidiaries should be presented in the consolidated financial statements. Accordingly, we think that paragraph 4(a)(iv) of IFRS 10 still applies when the investment entity parent, (Entity A) consolidates the investment-related services subsidiary (Entity S) and the intermediate parent (Entities B, C and D) has been accounted for at fair value through profit or loss in the consolidated financial statements of its investment entity parent in accordance with paragraph 31 of IFRS 10.
11. However, when considering the supplementary issue, we think that the situation is different if the investment entity parent (Entity A) does not have the

investment-related service subsidiary (Entity S) to consolidate. In that case, we think that each intermediate parent (Entities B, C and D) will need to present consolidated financial statements for their own sub-groups, because paragraph 4(a) (iv) of IFRS 10 is applicable only if ‘its ultimate or any intermediate parent produces consolidated financial statements’.

12. We think that this is contrary to the IASB’s intention in providing the consolidation exception to investment entities in order to provide relevant information and to reduce costs (see paragraph 25 of this paper). Whether the investment entity parent has a subsidiary that provides investment-related services or not should not change the availability of the exemption. This is particularly so because it is unlikely that investment-related service subsidiary (Entity S) would be material in quantitative terms in comparison to the size of the group as a whole. Accordingly, we recommend that paragraph 4 of IFRS 10 should be amended so that the exemption from presenting consolidated financial statements would be applicable to all intermediate-parent entities of an investment entity parent, provided that the other criteria in IFRS 10 paragraph 4 are met.

The Interpretations Committee’s view

13. The Interpretations Committee observed that an intermediate parent that does not provide investment-related services is included in its investment entity parent’s financial statements at fair value, and not through a line-by-line consolidation.
14. Some of the Interpretations Committee members questioned whether it was appropriate for such an intermediate parent to qualify for the exemption from the requirement to prepare consolidated financial statements if the intermediate parent was not itself an investment entity. Those members thought that intermediate parents that have subsidiaries should only be exempted from presenting consolidated financial statements if the intermediate parents’ accounts are reflected in the ultimate parent’s consolidated financial statements on a line-by-line basis.

Paragraph 4 of IFRS 10: stakeholders benefited from presenting consolidated financial statements of intermediate parents.

15. As a result of the Interpretation Committee's view, we conducted an analysis of the consequences of applying the exemption from the requirement to present consolidated financial statements for investment entities structures. More specifically, we analysed which users would benefit if intermediate parents (that are not investment entities) were no longer eligible to use the exemption in paragraph 4 of IFRS 10 and instead were to present consolidated financial statements. We have excluded intermediate parents that are investment entities because they are required to apply the consolidation exception in paragraph 4(c) of IFRS 10, which results in them accounting for their subsidiaries at fair value.
16. In order to apply the exemption in paragraph 4(a) of IFRS 10, entities need to meet all four criteria listed in paragraphs 4(a) (i), (ii), (iii) and (iv). Accordingly, an intermediate parent (that is not an investment entity) should meet all of the following three criteria in addition to criterion 4(a)(iv) of IFRS 10:
- (a) all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the intermediate parent not presenting consolidated financial statements;
 - (b) the intermediate parent's 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); and
 - (c) the intermediate parent 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.
17. We noted that the shareholders of the investment entity parent would use fair value-based information. Accordingly, if additional information is intended to be presented to shareholders of the investment entity parent, the information should be based on fair value, instead of on historical cost.
18. We also noted that minority shareholders of the intermediate parent may benefit from historical cost-based consolidated financial statements. However, we note that paragraph 4(a)(i) of IFRS 10 specifically addresses the needs of minority

shareholders separately: those minority shareholders can demand that the intermediate parent prepares consolidated financial statements. In addition, we noted that the exemption can only be used by intermediate parents that do not have, and are not in the process of issuing, debt or equity instruments traded in a public market in accordance with paragraph 4(a)(ii) and (iii) of IFRS 10. This offers some protection to the existing and potential holders of these instruments.

19. We also considered the needs of users other than shareholders. We noted that the *Conceptual Framework* names ‘existing and potential investors, lenders and other creditors’ as the primary users of general purpose financial reports.

OB5 Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.

20. Accordingly, we consider that lenders (for example, banks) and other creditors (for example, suppliers) of intermediate parents should form the basis of our analysis.

Cost and benefit of presenting historical cost-based consolidated financial statements of intermediate parents.

21. Before the introduction of *Investment Entities*, an intermediate parent that has an ultimate parent that is an investment entity that consolidated all investees was exempt from presenting consolidated financial statements. As already noted, the exemption is not available in cases in which minority shareholders disagree, or in which the intermediate parent’s debt or equity instruments are publicly traded or are in the process of being issued in a public market. Consequently, we think that our analysis should focus on whether the intermediate parent’s other lenders or creditors will be adversely affected by the inclusion of the intermediate parent at fair value in its parent’s financial statements instead of being consolidated on a line-by-line basis.
22. We think that these users (ie the intermediate parent’s other lenders and creditors) receive only limited information about the intermediate parent through the

consolidated financial statements of the ultimate parent using ordinary consolidation requirements. Accordingly, it is not clear whether these users' needs must be specifically addressed when the intermediate parents in the investment entity structures are included at fair value in the investment entity parent's financial statements or whether they should be consolidated on a line-by-line basis. In addition, in our experience, a bank that provides significant lending to an entity may have the ability to require certain periodic reporting to the bank as a condition of the loan. We also noted that in practice a supplier may use credit rating information instead.

23. These other users will have access to alternative information about the financial viability of the intermediate parents that are accounted for at fair value in the financial statements of the investment entity parent. The disclosure requirement of IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement* will apply to the investment entity's investments and will provide some relevant information. In addition, IFRS 12 *Disclosure of Interests in Other Entities* requires investment entities to provide specific disclosures relating to their unconsolidated subsidiaries. These disclosure requirements are reproduced in Appendix A of this paper.
24. Consequently, we do not think that it is clear what benefit would be gained by requiring all intermediate parents that are subsidiaries of investment entities to present historical cost-based consolidated financial statements. This is particularly so for intermediate parents in (any combination of) the following circumstances:
- (a) wholly owned intermediate parents (that are not investment entities);
 - (b) partially owned intermediate parents, for which minority shareholders do not require historical cost-based consolidated financial statements and therefore would not object to the application of the exemption from preparing consolidated financial statements;
 - (c) intermediate parents that do not have any borrowing from banks; and
 - (d) intermediate parents that do not have significant liability to creditors.
25. In addition, we consider that requiring all intermediate parent subsidiaries of investment entity parents to present consolidated financial statements could incur significant additional costs. We question whether the additional cost is justifiable

compared with the additional benefit. We are particularly concerned whether the benefits that the IASB expected from *Investment Entities* would be undermined by requiring all intermediate parent entities that are subsidiaries of investment entity parents to prepare consolidated financial statements. We note the following statements in the Basis for Conclusions of IFRS 10(emphasis added):

BC309 **The Board expects that the introduction of the exception to consolidation will result in significant compliance cost savings for preparers**, particularly on an ongoing basis. This expectation is based on the feedback the Board has received from respondents to the Investment Entities ED and conversations with entities that are expected to qualify as investment entities.

...

BC314 In general, these amendments will provide improved information about the fair values of investments and the way in which the fair value is measured. Such information could reduce the cost of analysis by providing information more directly to users of financial statements. However, in many cases, investment entities already provide investors with fair value information, although this is often done in an alternative report rather than in the financial statements. This serves to emphasise that **the main benefit of the changes is a reduction in costs to preparers because it eliminates what they see as a cumbersome reporting requirement that has little value.**

Staff recommendation

26. We continue to think that the exemption from preparing consolidated financial statements set out in paragraph 4(a) of IFRS 10 should be available to an intermediate parent entity that is a subsidiary of an investment entity but that is not an investment entity itself. In reaching this conclusion, we take note of the conditions set out in paragraph 4(a)(i), (ii) and (iii) of IFRS 10 that we think provide appropriate protection to the primary users of the intermediate parent’s financial statements.

27. In addition, we do not think that the other primary users of the financial statements of such intermediate parents are in a sufficiently worse position as a result of the amendments in *Investment Entities* to justify removing the existing exemption in paragraph 4(a) of IFRS 10. We think that the additional disclosures required by IFRS 12 go some way to alleviate any perceived loss of information that might result from incorporating the intermediate parent(s) at fair value instead of consolidating them on a line-by-line basis.
28. We therefore recommend that an amendment is made to IFRS 10 to clarify that the exemption in paragraph 4(a) of IFRS 10 is applicable to an intermediate parent entity that is a subsidiary of an investment entity that prepares financial statements in accordance with the requirements of IFRS 10.
29. We also recommend that this proposal for an amendment to IFRS 10 is to be combined with other proposed narrow-scope amendments to IFRS 10 that are being discussed in this meeting.

Questions for the IASB

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

Appendix A—Disclosure requirements for interests in unconsolidated subsidiaries of investment entities

- A1. IFRS 12 *Disclosure of Interests in Other Entities* requires certain additional information to be disclosed for its unconsolidated subsidiaries that are instead measured at fair value as follows:
- 19A An investment entity that, in accordance with IFRS 10, is required to apply the exception to consolidation and instead account for its investment in a subsidiary at fair value through profit or loss shall disclose that fact.
 - 19B For each unconsolidated subsidiary, an investment entity shall disclose:
 - (a) the subsidiary's name;
 - (b) the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary; and
 - (c) the proportion of ownership interest held by the investment entity and, if different, the proportion of voting rights held.
 - 19C If an investment entity is the parent of another investment entity, the parent shall also provide the disclosures in 19B(a)–(c) for investments that are controlled by its investment entity subsidiary. The disclosure may be provided by including, in the financial statements of the parent, the financial statements of the subsidiary (or subsidiaries) that contain the above information.
 - 19D An investment entity shall disclose:
 - (a) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements, regulatory requirements or contractual arrangements) on the ability of an unconsolidated subsidiary to transfer funds to the investment entity in the form of cash dividends or to repay loans or advances made to the unconsolidated subsidiary by the investment entity; and
 - (b) any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including

commitments or intentions to assist the subsidiary in obtaining financial support.

- 19E If, during the reporting period, an investment entity or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated subsidiary (eg purchasing assets of, or instruments issued by, the subsidiary or assisting the subsidiary in obtaining financial support), the entity shall disclose:
- (a) the type and amount of support provided to each unconsolidated subsidiary; and
 - (b) the reasons for providing the support.
- 19F An investment entity shall disclose the terms of any contractual arrangements that could require the entity or its unconsolidated subsidiaries to provide financial support to an unconsolidated, controlled, structured entity, including events or circumstances that could expose the reporting entity to a loss (eg liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or to provide financial support).
- 19G If during the reporting period an investment entity or any of its unconsolidated subsidiaries has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated, structured entity that the investment entity did not control, and if that provision of support resulted in the investment entity controlling the structured entity, the investment entity shall disclose an explanation of the relevant factors in reaching the decision to provide that support.