

STAFF PAPER

October 2014

IASB Meeting

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. The investment entities requirements were introduced when *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27) (the ‘Investment Entities Amendments 2012’) was issued in October 2012. The requirements are effective for annual periods beginning on or after 1 January 2014. Earlier application is permitted.
2. In preparing to apply the Investment Entity Amendments 2012 for the first time, some entities have identified some challenges in applying the requirements of paragraphs 31–32 of IFRS 10, particularly in multi-layer groups.
3. Paragraph 31 of IFRS 10 *Consolidated Financial Statements* requires an investment entity to measure all of its investments in subsidiaries at fair value through profit or loss. Paragraph BC272 of IFRS 10 explains that this requirement applies to subsidiaries that are themselves classified as investment entities.
4. Paragraph 32 of IFRS 10 provides an exception to the requirement in paragraph 31 for an investment entity to measure all of its investments in subsidiaries at fair value through profit or loss: if a subsidiary provides services that relate to the parent’s investment activities, as described in paragraphs B85C–B85E of IFRS 10, the investment entity shall consolidate that subsidiary.

5. The IFRS Interpretations Committee (the ‘Interpretations Committee’), and subsequently the IASB, were asked how to apply paragraph 32 of IFRS 10 when a subsidiary of an investment entity itself meets the definition of an investment entity *and* provides services that relate to the parent’s investment activities.
6. Both the Interpretations Committee and the IASB tentatively concluded that the consolidation requirement in paragraph 32 of IFRS 10 was not intended to be applicable to a subsidiary of an investment entity that was itself an investment entity. Consequently, in the Exposure Draft *Investment Entities: Applying the Consolidation Exception*, published in June 2014 (the ‘2014 ED’), the IASB proposed that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, applies only to those subsidiaries that act as an extension of the operations of the investment entity parent, *and* do not themselves qualify as investment entities.

Purpose of this paper

7. Given the urgency in timing and the limited scope of this and the other issues addressed in the 2014 ED, the IASB set a shortened comment period of 96 days. We are bringing the analysis of responses and staff recommendations to this October meeting because we think that it is important to provide clarifications of these issues during this year (2014).
8. The objective of this paper is to:
 - (a) present a summary of the responses received on the 2014 ED proposal;
 - (b) provide the staff’s analysis of the comments received and the staff’s conclusion on the issues raised; and
 - (c) recommend that the IASB finalise an amendment to IFRS 10:
 - (i) to confirm that an investment entity should measure at fair value all of its subsidiaries that are themselves investment entities;
 - (ii) to make clear that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, applies only to those subsidiaries that support the

investment entity parent's investment activities as an extension of the operations of the investment entity parent and are not themselves classified as investment entities; and

- (iii) to clarify the IASB's reasoning for its decisions, as outlined in the Basis for Conclusions on the 2014 ED, through amendments to the application paragraphs in Appendix B of IFRS 10, which relate to the business purpose of an investment entity, and in the related paragraphs of the Basis for Conclusions on IFRS 10.

Background information

9. The Appendix reproduces the proposed amendments to paragraphs 31–32 of IFRS 10, together with the related application paragraphs B85B–B85E, which are contained in the 2014 ED.
10. Paragraph BC272 of IFRS 10 explains that the Exposure Draft *Investment Entities*, issued in August 2011 (the 'Investment Entities ED'), proposed that an investment entity would measure all of its subsidiaries at fair value, even those investees who were themselves investment entities. Some respondents to the Investment Entities ED questioned this proposal and asked the IASB to consider whether 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).
11. Before finalising the Investment Entities Amendments 2012, the IASB discussed whether an investment entity should be required or permitted to consolidate some subsidiaries that are themselves investment entities, instead of measuring those subsidiaries at fair value.¹ As part of those deliberations, the IASB considered examples of different structures that some respondents suggested should be consolidated, such as master-feeder funds, fund-of-funds and wholly-owned investment entity subsidiaries established for legal, tax or regulatory purposes. At that time, the IASB decided to retain the proposal contained in the Investment Entities ED to require an investment entity to measure all subsidiaries that are

¹ See IASB Agenda Paper 8A, June 2012.

themselves investment entities at fair value. This decision was based on a number of factors, including:

- (a) the majority of constituents who commented on the IASB's proposals supported the IASB's approach of measuring all controlled investees of an investment company at fair value, unless the investee is an operating entity that provides services to the investment company parent.
- (b) requiring that the fair value measurement of an investment entity's investments in all of its investment entity subsidiaries is consistent with the basis for the investment entities exception; that is, that it provides more decision-useful information to investors than consolidation (except in the case of operating entities that provide services to the investment company parent).
- (c) several operational issues were raised by some respondents, including the need for the IASB to provide guidance about which investment entity subsidiaries should be consolidated and which should be measured at fair value, and how an investment entity subsidiary's portfolio(s) of investments should be accounted for. At the time, the IASB decided that there was no conceptual basis for distinguishing between different types of investment entity subsidiaries; that is, those formed for legal, tax or regulatory purposes and other business purposes (see paragraph BC272 of IFRS 10). Consequently, developing operational guidance to create such a distinction in order to determine which investment entity subsidiaries should be measured at fair value and which should be consolidated would be complex and time consuming (see paragraph BC9(a) of the 2014 ED).

Summary of comments received on the 2014 ED

12. A majority of respondents, approximately three quarters, agreed with the IASB's proposal to confirm that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, applies only to those subsidiaries that act as an extension of the operations of the investment entity parent, *and do*

not themselves qualify as investment entities. The reasons given for supporting the IASB's proposal are summarised in paragraphs 14–18.

13. A little over a quarter of those respondents that agree with the IASB's proposal commented that the issue did raise some application issues that may need more detailed consideration in due course. The issues raised are consistent with those set out in paragraphs 19–23, which were also raised by respondents who disagree with the proposal in the 2014 ED.

Reasons given for supporting the IASB's proposal

14. Paragraphs BC9–BC12 of the 2014 ED referred to the relevance of business purpose in the definition of an investment entity. Almost a quarter of the respondents who agree that an investment entity parent should measure at fair value all of its subsidiaries that qualify as an investment entity, supported their response by referring to the business purpose of the subsidiary. For example, Standard Chartered Bank PLC noted:

Our support is based on the fact that if a subsidiary of an investment entity performs investment related services as an extension of the investment entity parent, such subsidiary would not likely meet the definition of an investment entity under IFRS 10 which requires such subsidiary's business purpose to invest funds solely for returns from capital appreciation.

15. Similarly, the Irish Funds Industry Association noted:

An investment in an entity which is itself an investment entity is for the purpose of capital appreciation or investment income or both. We consider any provision of investment services by an entity which meets the definition of an investment entity to be incidental or ancillary to its primary purpose.

16. Several respondents referred to the relevance of fair value information when expressing their support for the proposal to confirm that all subsidiaries that are

themselves investment entities should be measured at fair value by an investment entity parent. For example, the Federation of European Accountants (FEE) noted:

... A subsidiary that provides support services and is not an investment entity itself can be seen as an extension of the parent investment entity. On the other hand, if a subsidiary which provides support services is itself an investment entity, then the fair value measurement basis provides more relevant and ready to use information to the users.

17. Some respondents agreed that the proposed amendment was consistent with the original decisions and intention of the IASB when it issued the Investment Entities Amendments 2012.
18. Some respondents, whether they agreed with the proposal or not, noted the importance of clarifying this issue quickly in order to improve the consistency of application of the requirements of IFRS 10 and avoid diversity developing.

Reasons given for not supporting the IASB's proposal

19. Approximately one quarter of respondents did not agree that the IASB should finalise the proposal in the 2014 ED to confirm that:
 - (a) all subsidiaries of an investment entity that are themselves investment entities should be measured at fair value; and
 - (b) the requirement to consolidate a subsidiary should be limited to subsidiaries that are not themselves investment entities and whose main purpose is to support the investment entity parent's investment activities by providing investment-related services or activities.
20. The most common reason given for the disagreement was a perceived loss of information about administrative costs, fee income, assets such as cash balances and liabilities such as borrowings used to support investments, which are included in both investment entity and non-investment entity subsidiaries in multi-layer group structures. For example, The Renewables Infrastructure Group (TRIG) noted:

We do not support this proposal because TRIG considers it is important to retain the ability to fully consolidate entities that provide services that relate to the investment entity's investment activities, regardless of whether the subsidiaries are classified as investment entities or not themselves, notably on the basis that the financial statements may otherwise exclude key useful information such as cash balances, short term debt and fund expenses carried or borne at subsidiary level that form an important part of the analysis of the TRIG group.

21. This comment reflects the disagreement of several respondents with the application of the consolidation exception to the subsidiary as a single unit of account. These respondents are generally asking for a change to IFRS 10 that would allow the consolidation of particular subsidiaries but with the 'roll-up' of the fair values used for the subsidiaries' investments. These subsidiaries are generally referred to as 'dual-purpose subsidiaries' or 'blockers'. This is because dual-purpose subsidiaries both provide investment-related services to, or on behalf of, the investment entity parent, *and* hold some investments. Blockers are wholly-owned intermediate holding entities that may not provide services but merely hold investments on behalf of the parent investment entity. These intermediate holding entities are typically established for legal, tax or regulatory purposes.
22. Several of the respondents noted that their disagreement with the proposed amendment in the 2014 ED is consistent with their disagreement with the original decision of the IASB to require intermediate holding entities established for legal, tax or regulatory purposes to be measured at fair value. This original decision is expressed in paragraph BC272 of IFRS 10, and demonstrated by Example 4 (paragraphs IE12–IE15) of the Illustrative Examples that accompany IFRS 10. Paragraph BC272 notes that some respondents to the Investment Entities ED suggested that at least some subsidiaries that are themselves investment entities should be consolidated (for example, wholly-owned investment entity subsidiaries that are created for legal, tax or regulatory purposes). Paragraph BC272 goes on

to note that, in finalising the original Investment Entities Amendments 2012, the IASB

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.

23. Several respondents noted that rule-based exceptions to principles produce a greater focus on the legal form of the group structure, instead of the substance or business purpose of the subsidiaries. This can create structuring opportunities and result in similar transactions being reported differently, merely because of where in the group the investment-related activities are placed. For example, 3i noted:

We are very grateful for the IASB's pragmatic approach in introducing the Investment Entity Exception and wholeheartedly support its intention to hold investment entities at fair value. However, perhaps surprisingly, we believe the current standard has become too wide ranging in requiring entities to be held at fair value, and we suggest that more entities should require consolidation. ... Having had time to reflect on the Investment Entity Exception in IFRS 10, we believe the standard needs to be less rules driven, applying more of a principles based approach. Otherwise, it is unlikely to result in the standard achieving the desired accounting in all of the many different group structures that are currently employed by investment entities. As proposed, the standard can result in different accounting treatments for the same economic transaction depending on the group structure it is executed through.

Suggestions made by respondents

24. Some respondents noted that, although it was appropriate to measure some investment entity subsidiaries at fair value, it was not appropriate in other cases. However, there is inconsistency in the suggestions as to which cases support consolidation and which support fair value measurement.
25. Some suggested that a ‘dual-model’ of consolidation should apply in cases in which an investment entity has a ‘dual-purpose subsidiary’; that is, a subsidiary that carries out some investment-related services and holds some investments. In some cases, the respondent did not distinguish between subsidiaries that are themselves investment entities and those that are not. This dual-model, it is suggested, would result in the line-by-line consolidation of the assets, liabilities and activities of the subsidiary, with the ‘roll up’ of the fair values used for its investments. For example, the British Private Equity and Venture Capital Association (BVCA) noted:

During the development of IFRS 10 we advocated a principles based approach whereby the definition of an investment entity would be based on the substance of the underlying entity. We pointed out the need to take into account that some structures meant that investment entities might have other activities alongside investments. However, we have always held the view that the fundamental principle is that investment entities should be able to show their investments at fair value while consolidating these other activities.

26. Several respondents, regardless of whether they agreed or disagreed with the proposal in the 2014 ED, suggested that the IASB should consider developing principles and/or guidance to identify when an investment entity should consolidate a subsidiary and when it should measure a subsidiary at fair value. For example, the Caisse de dépôt et placement du Québec (the ‘Caisse’) noted:

... the Caisse would like to make certain comments on the accounting of some subsidiaries, more specifically those that are created and wholly-owned by the Caisse for specific legal, tax, or regulatory purpose, and that are

described as intermediate subsidiaries (“blockers”), ... The Caisse proposes that the IASB consider certain criteria that could be analyzed by financial statement preparers and that could address the Board’s issue regarding the conceptual inability to distinguish between this type of intermediate subsidiary from other subsidiaries. For example, the Caisse proposes that an analysis of the facts and circumstances be carried out for this type of subsidiary in order to determine whether or not they should be consolidated.

27. The Caisse goes on to suggest some elements that could be considered in making this analysis. Similarly, KPMG noted:

We believe that it would be better to structure the requirements to introduce a principle that an investment entity should measure all subsidiaries (direct or indirect) in which it invests pursuant to the business purpose that qualifies it as an investment entity, with all other subsidiaries consolidated.

28. A small minority of respondents (less than five per cent) suggest that, if the IASB finalise the amendment as proposed, it should consider developing additional disclosure requirements. These respondents generally do not specify the disclosures that should be developed, although one respondent, Norsk RegnskapsStiftelse (the Norwegian Accounting Standards Board), suggests that ‘additional disclosures on total assets management costs (costs incurred both by the parent and by the subsidiary) should be required’.
29. Another small minority of respondents (less than five per cent) suggested that investment entities should be free to exercise judgement to decide when to measure investment entity subsidiaries at fair value and when to consolidate such subsidiaries.

Staff recommendation

30. The staff recommend that the IASB finalise an amendment to IFRS 10:
- (a) to confirm that an investment entity should measure at fair value all of its subsidiaries that are themselves investment entities;
 - (b) to make clear that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, applies only to those subsidiaries that support the investment entity parent's investment activities as an extension of the operations of the investment entity parent and are not themselves classified as investment entities; and
 - (c) to clarify the IASB's reasoning for its decisions, as outlined in the Basis for Conclusions on the 2014 ED, through amendments to the application paragraphs in Appendix B of IFRS 10, which relate to the business purpose of an investment entity, and in the related paragraphs of the Basis for Conclusions on IFRS 10.
31. We do not recommend developing specific disclosure requirements or new principles for distinguishing when or how an investment entity should consolidate an investment entity subsidiary or a dual-purpose subsidiary, instead of measuring that subsidiary at fair value.

Reasons supporting the staff recommendation

32. The staff considers that the IASB's previous decision to require an investment entity to measure all of its controlled investments in other investment entities at fair value was made sufficiently clear in the Staff Papers and *IASB Updates* published during the deliberations of the Investment Entities Amendments 2012. However, we acknowledge that the wording in paragraph 32 and related paragraphs in IFRS 10 do not reflect those decisions in a sufficiently clear way. Consequently, there is a risk of diversity developing if the IASB does not finalise an amendment to IFRS 10 in a timely manner.
33. As noted in paragraph 7, we think that it is important to provide clarity on this issue during this year (2014). We think that the limited amendments proposed

will provide clarity and reduce diversity, and can be drafted and issued in a timely manner. The limited amendments proposed are supported by the majority of respondents to the 2014 ED.

34. Many of the concerns expressed about the proposed amendments to paragraphs 32 and B85E of IFRS 10, and the suggestions for changes to the proposals, stem from concerns about, or disagreements with, the original decisions made by the IASB, which are reflected in the Investment Entities Amendments 2012. As noted previously, many of these issues have been considered, and rejected, by the IASB when finalising the Investment Entities Amendments 2012 (see paragraph 11).
35. We do not consider that it is appropriate to re-open the earlier debate on these issues because this is likely to create uncertainty and confusion. This, in turn, is likely to encourage diversity to develop. Instead, we think that the scope of this project should be restricted to providing clarity on the question that is addressed in the 2014 ED.
36. In addition, we do not support the suggestion from some respondents to develop principles and guidance to determine when an investment entity should consolidate a subsidiary (whether that subsidiary is itself an investment entity or not) and when it should measure a subsidiary at fair value. This would introduce a significant change to the existing requirements of IFRS 10, which requires that an investment entity should measure all of its subsidiaries at fair value, except those covered by the limited exception provided in paragraph 32 of IFRS 10.
37. Developing such principles and guidance would require a fundamental review and reconsideration of the original decisions and intentions of the IASB in issuing the Investment Entity Amendments 2012. This would be a time consuming exercise and would require extensive research and outreach activities. Such a review is beyond the scope and objective of this narrow-scope amendment project.
38. The purpose of this narrow-scope amendment project is to confirm when the limited exception in paragraph 32 of IFRS 10 applies, for which additional guidance is provided in the 2014 ED proposals. This additional guidance can be made clearer in the drafting of the subsequent amendments.

Additional disclosure requirements previously considered, and rejected, by the IASB

39. We do not support the suggestion to develop additional disclosures as part of this project. This is because the IASB has already considered and rejected similar suggestions before finalising the Investment Entities Amendments 2012.
40. In July 2012, the IASB considered whether an investment entity should provide specific disclosures about all of its investment activities, such as information about fund expenses and income, instead of merely disclosures about its investments. In addition, the IASB considered concerns raised by some respondents to the Investment Entities ED about the perceived loss of transparency related to information about the leverage of a subsidiary that is measured at fair value.² The July 2012 IASB *Update* reported that the IASB had tentatively decided that an investment entity should not be required to provide information about all of its investment activities. As a result, specific disclosures were introduced into IFRS 12 *Disclosure of Interests in Other Entities*, which focused on information about the investment entity's investments. These specific disclosures are required in addition to the general disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement*.
41. Again, we do not recommend re-opening this debate as part of this project but suggest that the need for additional disclosures is monitored.

Questions for the IASB

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Does the IASB agree with the staff's recommendation that the IASB finalise an amendment to IFRS 10:

- (a) to confirm that an investment entity should measure at fair value all of its subsidiaries that are themselves investment entities;
- (b) to make clear that the requirement for an investment entity to consolidate a subsidiary, instead of measuring it at fair value, applies only to those subsidiaries that support the investment entity

² See IASB Agenda Paper 8E and Supplement to 8E, July 2012

parent's investment activities as an extension of the operations of the investment entity parent and are not themselves classified as investment entities; and

- (c) to clarify the IASB's reasoning for its decisions, as outlined in the Basis for Conclusions on the 2014 ED, through amendments to the application paragraphs in Appendix B of IFRS 10, which relate to the business purpose of an investment entity, and in the related paragraphs of the Basis for Conclusions on IFRS 10.

Appendix: Proposed amendments to paragraphs 31–32 of IFRS 10, as published in the 2014 ED.

- A1. Paragraphs 31–32, B85B–B85E and BC272 of IFRS 10 are relevant to the issue being considered in this paper and thus are reproduced below. In the paragraphs that the 2014 ED proposed changes to, deleted text is struck through and new text is underlined.
- A2. 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.
- A3. If a subsidiary provides services that relate to the investment entity parent’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 is not~~ itself an investment entity and whose main purpose is to provide 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.
- A4. Paragraphs B85B–B85E of IFRS 10 provide guidance on the business purpose of an investment entity as follows:
- B85B The definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both. Documents that indicate what the entity’s investment objectives are, such

as the entity's offering memorandum, publications distributed by the entity and other corporate or partnership documents, will typically provide evidence of an investment entity's business purpose. Further evidence may include the manner in which the entity presents itself to other parties (such as potential investors or potential investees); for example, an entity may present its business as providing medium-term investment for capital appreciation. In contrast, an entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees has a business purpose that is inconsistent with the business purpose of an investment entity, because the entity will earn returns from the development, production or marketing activity as well as from its investments (see paragraph B85I).

- 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.
- B85E If an investment entity has a subsidiary that ~~provides~~ is not itself an investment entity and whose main purpose

is to support the investment entity's investment activities by providing investment-related services or activities, such as those described in paragraphs B85C–B85D, to the entity or other parties, it shall consolidate that subsidiary in accordance with paragraph 32. If the subsidiary that provides the investment-related services or activities is itself an investment entity, the investment entity parent shall measure the subsidiary at fair value through profit or loss in accordance with paragraph 31.

- A5. In the Basis of Conclusions to IFRS 10, paragraph BC272 notes that the IASB previously considered, and rejected, requiring or permitting an investment entity to consolidate some subsidiaries that qualify as investment entities, instead of measuring them at fair value.

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.