

## STAFF PAPER

November 2016

IFRS<sup>®</sup> Interpretations Committee Meeting

<b>Project</b>	<b>IFRS 10 <i>Consolidated Financial Statements</i></b>		
<b>Paper topic</b>	Investment Entities—Consolidation of subsidiaries		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (the Interpretations Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Interpretations Committee or the International Accounting Standards Board (the Board) can make such a determination. Decisions made by the Interpretations Committee are reported in IFRIC<sup>®</sup> *Update*. The approval of a final Interpretation by the Board is reported in IASB<sup>®</sup> *Update*.

## Introduction

1. The IFRS Interpretations Committee (the Interpretations Committee) received a request regarding the assessment of whether an investment entity parent consolidates a subsidiary in specified circumstances.
2. The objective of this paper is to:
  - (a) provide the Interpretations Committee with a summary of the issue and the staff's research and analysis; and
  - (b) ask the Interpretations Committee if it agrees with the staff recommendation not to add the issue to its agenda.

## Structure of the paper

3. This paper includes:
  - (a) background information;
  - (b) staff analysis;
  - (c) assessment against the Interpretations Committee's agenda criteria;

- (d) staff recommendation; and
  - (e) questions for the Interpretations Committee.
4. Appendix A to the paper outlines the proposed wording of the tentative agenda decision. The submission is reproduced in Appendix B to the paper.

### Background information

5. Paragraph 31 of IFRS 10 *Consolidated Financial Statements* requires an investment entity that has subsidiaries (ie a parent investment entity (PIE)) to generally measure its investments in subsidiaries at fair value through profit or loss. The PIE does not consolidate its subsidiaries, with one limited exception specified in paragraph 32 of IFRS 10.
6. In December 2014, the International Accounting Standards Board (the Board) amended paragraph 32 of IFRS 10 to clarify that a PIE consolidates only subsidiaries:
- (a) that are not investment entities; and
  - (b) whose main purpose and activities are providing services that relate to the PIE's investment activities.

This amendment is effective for annual reporting periods beginning on or after 1 January 2016.

7. The submitter has identified the potential for diversity in how a PIE assesses whether it consolidates a subsidiary applying paragraph 32 of IFRS 10. The submitter asks the following four questions:
- (a) does a subsidiary qualify as an investment entity if it possesses all three elements described in paragraph 27 of IFRS 10, but does not have all of the typical characteristics of an investment entity listed in paragraph 28 of IFRS 10? (*Question I*)

- (b) does a subsidiary provide investment management services to investors (as specified in paragraph 27(a) of IFRS 10) if it outsources the provision of these services to a third party? (*Question II*)
  - (c) does a subsidiary provide services that relate to the PIE's investment activities (as specified in paragraph 32 of IFRS 10) if it holds an investment portfolio as beneficial owner and has no other activity? (*Question III*)
  - (d) to what extent can an investment entity provide investor-related services, itself or through a subsidiary, to third parties? (*Question IV*)
8. Further background information about these questions, together with the alternative views identified by the submitter, is outlined in Appendix B to this paper, which reproduces the submission.

## Staff analysis

### ***Question I—Qualification of a subsidiary as an investment entity***

#### *Fact pattern in the submission*

9. The submitter describes a situation in which a subsidiary of the PIE possesses all three elements of the definition of an investment entity listed in paragraph 27 of IFRS 10, but has only one related investor. The subsidiary, therefore, does not have the typical characteristics of an investment entity listed in paragraphs 28(b) and 28(c) of IFRS 10 (ie an investment entity typically has more than one investor, and its investors are typically not related parties of the investment entity).
10. The submitter asks if the subsidiary qualifies as an investment entity if it possesses all three elements described in paragraph 27 of IFRS 10, but does not have all of the typical characteristics of an investment entity listed in paragraph 28 of IFRS 10.

*Analysis:*

## 11. Paragraph 27 of IFRS 10 states:

A parent shall determine whether it is an investment entity. An investment entity is an entity that:

- (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

## 12. Paragraph 28 of IFRS 10 states:

In assessing whether it meets the definition described in paragraph 27, an entity shall consider whether it has the following typical characteristics of an investment entity:

- (a) it has more than one investment (see paragraphs B85O–B85P);
- (b) it has more than one investor (see paragraphs B85Q–B85S);
- (c) it has investors that are not related parties of the entity (see paragraphs B85T–B85U); and
- (d) it has ownership interests in the form of equity or similar interests (see paragraphs B85V–B85W).

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. An investment entity that does not have all of these typical characteristics provides additional disclosure

required by paragraph 9A of IFRS 12 *Disclosure of Interests in Other Entities*.

13. In addition, paragraph B85A of IFRS 10 states:

An entity that possesses the three elements of the definition of an investment entity set out in paragraph 27 is an investment entity.
14. The presence of the typical characteristics in paragraph 28 of IFRS 10 is not intended to constitute additional criteria that entities must meet in order to qualify as an investment entity. This is stated in that paragraph, which emphasises that the absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity.
15. Similarly, paragraph B85N of IFRS 10 clarifies that ‘the absence of one or more of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity but indicates that additional judgement is required in determining whether the entity is an investment entity’. Paragraphs B85O-B85W of IFRS 10 provide application guidance on the typical characteristics of an investment entity, and includes examples of investment entities that may not have one or more of these characteristics.
16. In the fact pattern described in the submission, the subsidiary possesses the three elements of the definition of an investment entity in paragraph 27 of IFRS 10. Accordingly, the subsidiary is an investment entity.

*Staff conclusion:*

17. A subsidiary that possesses all three elements of the definition of an investment entity in paragraph 27 of IFRS 10 is an investment entity. This is so even if it does not have all of the typical characteristics of an investment entity described in paragraph 28 of IFRS 10.

**Question II—Outsourcing investment management services to a third party**

*Fact pattern in the submission*

18. The submitter describes a situation in which a subsidiary of the PIE would otherwise possess all three elements of the definition of an investment entity listed in paragraph 27 of IFRS 10 but outsources the provision of investment management services to a third party. The submitter asks if the subsidiary provides investment management services to investors (as specified in paragraph 27(a) of IFRS 10) if the subsidiary outsources the provision of these services to a third party.

*Analysis:*

19. Paragraph 27(a) of IFRS 10 states:

...An investment entity is an entity that:

- (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; ...

20. Paragraph BC237 of IFRS 10 states:

The Board noted that one of the essential activities of an investment entity is that it obtains funds from investors in order to provide those investors with investment management services. The Board believes that this provision of investment management services differentiates investment entities from other entities. Consequently, the Board decided that the definition of an investment entity should state that an investment entity obtains funds from an investor or investors and provides the investor(s) with investment management services.

21. Paragraph 27(a) of IFRS 10 requires an investment entity to provide investment management services to investors—the reasons for doing so are explained in

paragraph BC237 of IFRS 10. These paragraphs do not specify how an investment entity provides those services.

22. In our view, this requirement means that an investment entity must be responsible to its investors for providing them with investment management services. We think that an entity can satisfy its obligation to provide those services to investors either directly or by engaging another party to perform some or all of those services on its behalf. In our view, the requirement to provide investment management services to investors does not preclude an investment entity from outsourcing the performance of those services to a third party.

*Staff conclusion:*

23. The subsidiary provides investment management services to investors (as required by paragraph 27(a) of IFRS 10 to qualify as an investment entity), even if it outsources the performance of these services to a third party.

**Question III—Subsidiary holding an investment portfolio with no other activities**

*Fact pattern in the submission*

24. The submitter describes a situation in which a subsidiary holds investments as beneficial owner and recognises these investments as assets in its separate financial statements. The subsidiary has no other activity.
25. The submitter asks if the subsidiary provides services that relate to the PIE’s investment activities (as specified in paragraph 32 of IFRS 10).

*Analysis:*

26. Paragraph 32 of IFRS 10 requires a PIE to consolidate a subsidiary that is not itself an investment entity and whose main purpose and activities are providing services that relate to the investment entity’s investment activities. IFRS 10 does not define ‘services that relate to the investment entity’s investment activity’. Paragraphs

B85C–B85D of IFRS 10 provide examples of investment-related services, which include investment advisory services, investment management, investment support and administrative services.

27. The Interpretations Committee previously discussed whether an investment entity consolidates an intermediate subsidiary set up for tax optimisation purposes when the subsidiary does not perform any activities (other than holding the investments). The Interpretations Committee commented on paragraph BC272 of IFRS 10, which outlines the Board’s considerations in deciding which subsidiaries an investment entity consolidates. Paragraph BC272 of IFRS 10 states:

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.



28. The agenda decision issued in [March 2014](#) states (emphasis added):

...The Interpretations Committee noted that, according to paragraph BC272 of IFRS 10, the IASB thinks that fair value measurement of all of an investment entity's subsidiaries would provide the most useful information, except for subsidiaries providing investment-related services or activities. In addition, the Interpretations Committee noted that the IASB had considered requiring an investment entity to consolidate investment entity subsidiaries that are formed for tax purposes, but had decided against this.

The Interpretations Committee noted that one of the characteristics of 'tax optimisation' subsidiaries described in the submission is "that *there is no activity within the subsidiary*". Accordingly, the Interpretations Committee considers that the parent should not consolidate such subsidiaries, because *they do not provide investment-related services or activities*, and do not meet the requirements to be consolidated in accordance with paragraph 32 of IFRS 10. The parent should therefore account for such an intermediate subsidiary at fair value...

29. The Interpretations Committee concluded in 2014 that the holding of investments alone does not constitute the provision of investment-related services by the subsidiary.

*Staff conclusion:*

30. We see no reason to now conclude differently applying the existing requirements in IFRS 10. The holding of investments does not constitute a service provided by the subsidiary that relates to the PIE's investment activities as described in paragraph 32 of IFRS 10. Consequently, a PIE does not consolidate a subsidiary that has no activity other than to hold investments as beneficial owner.

**Question IV—To what extent can an investment entity provide investment-related services, through a subsidiary, to third parties?**

*Fact pattern in the submission*

31. The submitter describes a situation in which a PIE has a non-investment entity subsidiary that provides investment management services to third parties. The submitter asks if the significance of the investment management services provided by the subsidiary could result in the parent failing to meet the definition of an investment entity.

*Analysis*

32. Paragraph 32 of IFRS 10 requires a PIE to consolidate non-investment entity subsidiaries whose main purpose and activities are providing services that relate to the PIE's investment activities. Consequently, as a first step, the PIE assesses whether the investment management services provided by the subsidiary to third parties are related to the PIE's investment activities. In this respect, the Basis for Conclusions on IFRS 10 says the following:

BC240E The Board noted that the requirement in paragraph 32 of IFRS 10 to consolidate particular subsidiaries of an investment entity was intended to be a limited exception, capturing only operating subsidiaries that support the investment entity parent's investing activities as an extension of the operations of the investment entity parent. It was not intended to capture subsidiaries that are themselves investment entities. The definition of an investment entity requires that the investment entity's business purpose and, therefore, its core activity is providing investment management services to its investors and investing the funds obtained from its investors solely for returns from capital appreciation, investment income, or both. When the Board decided that providing investment-related services to third parties would not prevent an entity from qualifying as an investment entity, it

recognised that investment entities could benefit from synergies between the core investing activities and the provision of investment-related services to third parties.

33. We note that there might be situations in which a non-investment entity subsidiary provides investment management services that are not related to the PIE’s investment activities. For example, a PIE might, as part of its activities to invest funds for returns from capital appreciation, investment income, or both, invest in an entity whose business purpose is to provide investment-related services in exchange for fees from third parties. In such a case, the subsidiary is not acting as an extension of the operations of PIE. Instead, it is operating as a fee-earning business in its own right. Consequently, the PIE measures the subsidiary at fair value through profit or loss, as it does for other portfolio investments made as part of its investment activities.
34. Having determined whether the non-investment entity subsidiary is classified as a portfolio investment or as an extension of the PIE, the PIE then considers the investment-related services that it provides to third parties, either directly or through subsidiaries. It does so in assessing whether it meets the element of the investment entity definition in paragraph 27(b) of IFRS 10. Paragraph 27(b) of IFRS 10 specifies that the business purpose of an investment entity is to invest funds solely for returns from capital appreciation, investment income, or both. With respect to third party services, paragraph B85C of IFRS 10 states (emphasis added):

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, *subject to the entity continuing to meet the definition of an investment entity.*

35. In explaining the basis for the Board’s decisions regarding third-party services, paragraph BC239, BC240 and BC240F of IFRS 10 state the following:

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).

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 parties 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.

....

BC240F The Board noted that, therefore, when an entity assesses whether it qualifies as an investment entity, it considers whether providing services to third parties is ancillary to its core investing activities. However, 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 and rental income) or both (see paragraph B85B of IFRS 10). Consequently, an entity whose main purpose is to provide investment-related services in exchange for consideration from third parties has a business purpose that is different from the business purpose of an investment entity. This is because the entity's main activity is earning fee income in exchange for its services. In contrast, for an entity that qualifies as an investment entity, such fee income, which could be substantial in amount, will be derived from its core investment activities, which are designed for earning capital appreciation, investment income or both.

36. IFRS 10 acknowledges that investment related services provided to third parties may be substantial in some cases—for example, as explained in paragraph BC240F above, the fee income earned by the PIE and its subsidiaries could be substantial in amount. However, this alone would not preclude the entity from qualifying as an investment entity, as long as these activities are ancillary to the PIE's core investing activities.
37. Accordingly, in assessing the element of the investment entity definition in paragraph 27(b) of IFRS 10, the PIE considers whether investment management services provided to third parties (both directly and through subsidiaries) is ancillary to its core investing activities. To qualify as an investment entity, the PIE can provide services to third parties (even if substantial), as long as these services are not of such significance that they change the business purpose of the PIE.
38. In most cases, we expect that it will be clear that the business purpose of an entity is (a) to invest solely for capital appreciation, investment income, or both (and thus it is an investment entity if it also possesses the other two elements of the investment entity definition) or, alternatively, is (b) to provide investment-related services to third parties (and thus it is not an investment entity). However, in some cases, an entity may need to apply judgement.

*Staff conclusion:*

39. An investment entity, together with its subsidiaries, can provide investment-related services to third parties (even if those services are substantial), as long as those services are ancillary to its core investing activities and, thus, do not change the business purpose of the investment entity.

**Assessment against the Interpretations Committee’s agenda criteria**

40. Our assessment of the Interpretations Committee’s agenda criteria is as follows:<sup>1</sup>

Paragraph 5.16 of the Due Process Handbook states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	<b>Met.</b> We understand that the situations described by the submitter can arise frequently in practice. The difference between consolidating a subsidiary and measuring the subsidiary at fair value could be material for an investment entity.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	<b>Not met.</b> Based on our analysis, we think the requirements in IFRS Standards provide an adequate basis to enable an entity to determine the appropriate accounting. We think an Interpretation or an amendment to an existing Standard is not needed to improve financial reporting.
that can be resolved efficiently within the confines of existing IFRS Standards and the <i>Conceptual Framework for Financial Reporting</i> .	Not applicable

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<sup>1</sup> These criteria can be found in the [IFRS Foundation Due Process Handbook](#) .

Paragraph 5.16 of the Due Process Handbook states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable
The solution developed should be effective for a reasonable time period (paragraph 5.21).	Not applicable

### Staff recommendation

41. On the basis of our analysis, we think that the principles and requirements in IFRS Standards provide an adequate basis to enable an entity to determine how to account for its subsidiary in each of the specified situations. On the basis of our assessment of the Interpretations Committee’s agenda criteria, we recommend that the Interpretations Committee does not add this issue to its agenda.
42. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

**Questions for the Interpretations Committee**

1. Does the Interpretations Committee agree with the staff recommendation not to add this issue to its agenda?
2. Does the Interpretations Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

**Appendix A—Proposed wording for tentative agenda decision****IFRS 10 Consolidated Financial Statements —Investment entities and subsidiaries**

The IFRS Interpretations Committee (the Interpretations Committee) received a request regarding the assessment of whether an investment entity that has subsidiaries (ie a parent investment entity (PIE)) consolidates a subsidiary in specified circumstances. The submitter asked the following four questions:

- (a) does a subsidiary qualify as an investment entity if it possesses all three elements described in paragraph 27 of IFRS 10, but does not have all of the typical characteristics of an investment entity listed in paragraph 28 of IFRS 10? (*Question I*)
- (b) does a subsidiary provide investment management services to investors (as specified in paragraph 27(a) of IFRS 10) if it outsources the provision of these services to a third party? (*Question II*).
- (c) does a subsidiary provide services that relate to the PIE's investment activities (as specified in paragraph 32 of IFRS 10) if it holds an investment portfolio as beneficial owner and has no other activity? (*Question III*)
- (d) to what extent can an investment entity provide investment-related services, itself or through a subsidiary, to third parties? (*Question IV*)

*Question I*

Paragraph 27 of IFRS 10 lists the three elements an entity must possess to qualify as an investment entity. Paragraph 28 of IFRS 10 lists typical characteristics that an entity considers in assessing whether it possesses all three elements in paragraph 27. Paragraph 28 also says that the absence of any of these characteristics does not necessarily disqualify an entity from being an investment entity. In addition, paragraph B85A of IFRS 10 emphasises that an entity that possesses the three elements of the definition of an investment entity set out in



paragraph 27 is an investment entity.

Accordingly, the Interpretations Committee concluded that a subsidiary that possesses all three elements of the definition of an investment entity in paragraph 27 of IFRS 10 is an investment entity. This is the case even if the subsidiary does not have all of the typical characteristics of an investment entity specified in paragraph 28 of IFRS 10.

#### *Question II*

Paragraph 27(a) of IFRS 10 requires an investment entity to provide investors with investment management services. IFRS 10 does not specify how the investment entity must provide these services, and for example does not preclude it from outsourcing the performance of these services to a third party.

Accordingly, the Interpretations Committee concluded that a subsidiary provides investors with investment management services (as specified in paragraph 27(a) of IFRS 10) even if it outsources the performance of these services to a third party.

#### *Question III*

The Interpretations Committee observed that it had previously discussed an issue similar to Question III. At its meeting in [March 2014](#), the Interpretations Committee issued an agenda decision noting its conclusion that a subsidiary does not provide investment-related services or activities if the subsidiary holds investments for tax optimisation purposes and there is no activity within the subsidiary.

Similarly, the Interpretations Committee concluded that a PIE does not consider the holding of investments by a subsidiary as beneficial owner (and recognised on the subsidiary's separate financial statements) to be a service that relates to the PIE's investment activities (as specified in paragraph 32 of IFRS 10), in the absence of any other investment-related activities undertaken by the subsidiary.

*Question IV*

Paragraph 27(b) of IFRS 10 requires that the business purpose of an investment entity is to invest solely for capital appreciation, investment income, or both.

Paragraph 85C of IFRS 10 says that an investment entity may provide investment-related 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, subject to the entity continuing to meet the definition of an investment entity.

The Interpretations Committee noted that to be an investment entity, services provided to third parties cannot be of such significance that they change the business purpose of the entity from investing as specified in paragraph 27(b) of IFRS 10 to providing investment-related services to third parties. The Interpretations Committee concluded, therefore, that an investment entity (together with its subsidiaries) may provide investment-related services to third parties, subject to those services being ancillary to the investment entity's core investing activities.

For all four questions (ie Question I – Question IV), the Interpretations Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis to enable an entity to determine how to account for its subsidiary in each of the specified circumstances.

In the light of the existing requirements in IFRS Standards, the Interpretations Committee [determined] that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee [decided] not to add this issue to its agenda.

## Appendix B—Submission<sup>2</sup>

Dear Sir,

### Potential Interpretations Committee Agenda Item Request

This letter describes issues that we believe should be added to the agenda of the IFRS Interpretations Committee. We have included a summary of the issues, alternative views and an assessment against the Interpretations Committee criteria.

#### **The topic – application of the amended IFRS 10.32 is leading to diversity in practice regarding intermediate entities**

Under IFRS 10.31-32, as applicable from 1 January 2016, an investment entity consolidates a subsidiary that meets both of the following conditions:

- it is not itself an investment entity; and
- its main purpose and activities are providing services that relate to the investment entity parent's investment activities.

There is diversity in practice for the application of this in situations, first, in which a portfolio of investments is held by an intermediate subsidiary (ICo) of the parent investment entity (PIE). Some investment entity parents conclude that the intermediary subsidiary is to be consolidated, whereas others conclude that it is to be measured at fair value through profit or loss. Diversity in practice also arises in respect of the provision of investment management activities, through a subsidiary of PIE that is not an investment entity (SCo), to third parties.

We believe that the Interpretations Committee should address the issues because the potential outcomes could have a significant effect on the financial statements (by affecting the granularity of information in the primary statements), and consistency in this area is desirable.

We have identified four particular questions of principle that need to be addressed with a high priority.

In the appendix we have included four example scenarios for which one or more of these questions are decisive to the question of consolidation versus fair value accounting. This submission does not seek the Committee's resolution of the scenarios as such, but they are merely to illustrate the practical relevance of the four questions of principle that form this submission.

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<sup>2</sup> We have deleted details that could identify the submitter of the request.

## Question 1

Does ICo qualify as an investment entity if it fulfils all three essential elements of the investment entity definition per IFRS 10.27 but has only two out of four typical characteristics per IFRS 10.28 (having a single, related investor it does not meet IFRS 10.28(b) and (c))?

### *View 1.1 – free choice*

As the typical characteristics are mixed and so not conclusive, there is nothing to indicate that one answer is superior to another. So an entity may make a free choice as to whether ICo is an investment entity.

### *View 1.2 – not an investment entity*

An informed decision rather than a free choice must be made. That decision is informed by IFRS 10.BC240H:

“If the subsidiary is not an investment entity, the investment entity parent assesses whether the main activities undertaken by the subsidiary support the core investment activities of the parent. If so, the subsidiary’s activities are considered to be an extension of the parent’s core investing activities and the subsidiary would be consolidated in accordance with paragraph 32 of IFRS 10.”

Since ICo undertakes the investment and management of funds obtained by PIE from investors, then ICo’s activities are an extension of those of PIE. Therefore ICo should be consolidated and hence it is not an investment entity.

### *View 1.3 – an investment entity*

There is no free choice, but the analysis in view 1.2 is an inappropriate reading of IFRS 10.BC240H. That paragraph outlines a consequence, i.e. a subsidiary being considered to be an extension of its parent investment entity, of that subsidiary’s failing the investment entity (and services) test(s). View 1.2 posits the reverse, arguing that the consequence exists and then inferring that the test must be failed. That is not a logical proposition and avoids addressing the actual test of an investment entity.

Instead IFRS 10.IE15, dealing with master / feeder structures, is the appropriate point of reference. This explains that IFRS 10.28(b) and (c) are present by looking at the master and feeder together given that they were formed in connection with each other for legal, regulatory or tax requirements. There is no difference between the circumstance addressed by question 1 (e.g. scenario A in the appendix) and a master / feeder structure. The same answer therefore applies, i.e. IFRS 10.28(b) and (c) should be considered met and there is no case for anything other than ICos being an investment entity.

## Question 2

If ICo has outsourced the provision of investment management services to a third party, does it fail the essential element in IFRS 10.27(a) (provision of investment management services)?

*View 2.1 – fails IFRS 10.27(a)*

ICo on its own does not provide investment management services as these are outsourced to a third party. Merely overseeing the third party's performance of the sub-contract is not the same as conducting investment management services. It therefore fails the essential element in IFRS 10.27(a) and does not qualify as an investment entity.

*View 2.2 – meets IFRS 10.27(a)*

If PIE itself had entered into the contract with the third party for the outsourcing of the investment management services (quite a common occurrence), it would not fail the essential element in IFRS 10.27(a) (and we believe that there is no diversity in practice in that regard). It is responsible to its investors for delivering investment management services, and how it fulfils that is a different matter. ICo is in exactly the same position. Accordingly, ICo fulfils IFRS 10.27(a).

### Question 3

Is the mere holding by ICo of an investment portfolio, as beneficial owner and recognised on ICo's separate financial statements balance sheet, a service provided by ICo that relates to the investment activities of PIE, as referred to in IFRS 10.32?

#### *View 3.1 – free choice*

Investment related services are not defined in IFRS 10, which includes only a non-exhaustive list of examples in IFRS 10.B85C: investment advisory services, investment management, investment support and administrative services. As a result, there is room for interpretation about which services provided by a subsidiary qualify as services that relate to an investment entity's investment activities. Therefore an entity may make a free choice as to whether the holding of investments is such a service.

#### *View 3.2 – a service related to PIE's investment activities*

Holding the investments is a service. That service relates to PIE's investment activities, as these are the investments that PIE has made with its investor's funds and which it manages. Therefore it is a service related to PIE's investment activities.

#### *View 3.3 – not a service related to PIE's investment activities*

ICo is holding investments on its own account and therefore that activity does not involve a service to PIE:

- In law ICo is the beneficial owner of the investments, so it is not holding them as an agent or trustee, whereas, in contrast, holding investments as a trustee would be a service, e.g. as provided by custodians.
- Nor could ICo be considered for accounting purposes to be treated as holding the investments as an agent or trustee, as that would be inconsistent with continued recognition of the investments in its separate financial statements.
- PIEs benefit from the investments arises simply out of its ownership of 100% of ICo's equity. It is ICo's mere existence as a 100% subsidiary that brings benefit to PIE, not any activity that ICo undertakes.

In addition, the holding of investments is the same key fact as in the case considered by the Interpretations Committee in March 2014:

“Some investment entities establish wholly-owned intermediate subsidiaries in some jurisdictions, which own all or part of the portfolio of investments in the group structure. The Interpretations Committee noted that one of the characteristics of ‘tax optimisation’ subsidiaries described in the submission is ‘that there is no activity within the subsidiary’. Accordingly, the Interpretations Committee considers that the parent should not consolidate such subsidiaries, because they do not provide investment-related services or activities.”

The Committee did not consider the mere holding of investments to be a service to the parent investment entity. That analysis applies to this case as the essential fact is the same.

#### Question 4

To what extent may investment activities include third party services?

*View 4.1 – substantial to PIE*

IFRS 10 provides that investment activities can be substantial if either provided directly by the PIE or through a subsidiary:

- IFRS 10.B85C allows an investment entity to provide “investment related services.... either directly or through a subsidiary, to third parties, as well as its investors, even if those activities are substantial.”

This carries over to the position of SCo:

- IFRS 10.BC239 notes that the business purpose of an investment entity can include the provisions of third party services: “The Board agreed with these arguments [that third party services be permitted], 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).”
- Thus any services that SCo provides that relate to this activity, e.g. if part or all of SCo’s activity is the provision of such third party services, are services that relate to PIE’s investment activities. This is also acknowledged by in IFRS 10 B85E, which refers to “the provision of investment related services or activities that relate to the investment entity’s activities ... to the entity or other parties.”

*View 4.2 – ancillary to PIE*

The extent of services, whether directly or through a subsidiary, must be merely ancillary:

- IFRS 10.BC240F states that, “The Board noted that, therefore, when an entity assesses whether it qualifies as an investment entity, it considers whether providing services to third parties is ancillary to its core investing activities.”
- Such a restriction of third party services ensures that the entity remains within the basic definition of an investment entity. IFRS 10.BC240F goes on to explain this: “However, 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 and rental income), or both (see paragraph B85B of IFRS 10). Consequently, an entity whose main purpose is to provide investment-related services in exchange for consideration from third parties has a business purpose that is different from the business purpose of an investment entity. This is because the entity’s main activity is earning fee income in exchange for its services.”

This carries over to SCo in the same way as for view 4.1, i.e. if the provision of third party services qualifies as an ancillary part of PIE’s investment activities, then anything that SCo does in furtherance of that ancillary service must relate to PIE’s investment activities.

### Reasons for the Interpretations Committee to address the issues

- a) *Is the issue widespread and practical?*** Yes. We believe that investment entity group structures involving intermediary subsidiaries managing and / or holding investments are very common.
- b) *Does the issue involve significantly divergent interpretations?*** Yes. Depending on the interpretation applied, the decision on how to account for the intermediary subsidiaries could have a significant effect on an investment entity's financial statements.
- c) *Would financial reporting be improved through elimination of the diversity?*** Yes. The comparability of financial statements would be improved if investment entities applied the same accounting for intermediary subsidiaries having the same characteristics.
- d) *Is the issue sufficiently narrow?*** Yes. It is concerned with the application of specific paragraphs of IFRS 10 to specific questions.
- e) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*** The issue might be thought to be related to the Post-Implementation Review (PIR) of IFRS 10. This is not due to start within the next six months. We believe that the issue is far more pressing than that and should be addressed with a higher priority to ensure clarifying guidance is provided as soon as possible to preparers of financial statements for the year ended 31 December 2016, the year for which the clarified paragraph 32 is first applicable.



## Appendix – example scenarios for which one or more of the three questions is key

Four main fact patterns illustrate the four questions. Each involves a parent company (PIE) meeting the investment entity criteria in accordance with IFRS 10. PIE then wholly owns and funds an intermediary subsidiary (ICo) that holds an investment portfolio; or PIE has a subsidiary, SCo, that does not hold an investment portfolio. The peculiarity of each scenario relates to the particulars of ICo or SCo, as follows.

- Scenario A – ICo fulfils the essential elements of the investment entity definition per IFRS 10.27, including that it employs personnel managing its investment portfolio (IFRS 10.27(a)).

If it is an investment entity under question 1, then it will be fair value accounted; otherwise it will be consolidated (the investment management services are services related to PIE's investment activities).

- Scenario B – The facts are the same as scenario A save that ICo does not have any employees and has outsourced the provision of investment management services to a third party.

If at question 2 this meets IFRS 10.27(a), then as with scenario A, its consolidation or not is determined by question 1 and the typical characteristics. If at question 2 it does not meet IFRS 10.27(a), then its consolidation or not will depend on question 3.

- Scenario C – Nothing else occurs in ICo other than its holding of the investment portfolio, as beneficial owner, according to the parent's decisions. It recognises the investments in its separate financial statements (i.e. other standards do not lead to derecognition). It therefore does not fulfil the essential element of the investment entity definition in IFRS 10.27 (e.g. it does not provide any investment management services – IFRS 10.27(a)).

Not being an investment entity, its consolidation or not turns on question 3.

- Scenario D – SCo holds no investments but provides investment management services to third parties.

If, at question 4, the investment management services provided by the PIE group to third parties are permitted, then, for the reason that follows, SCo would be consolidated: the provision of third party investment management services is part of PIE's investment activities and SCo's sole activity is providing a service that relates to that activity.