

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2011/14 INVESTMENT ENTITIES



Overview

During the development of IFRS 10 *Consolidated Financial Statements*, many respondents asked the IASB to reconsider whether investment entities should be exempted from consolidating their controlled investments. They argued that the most useful information for an investor in these entities is the fair value of the underlying investments. It was also noted that some other national accounting requirements already allow such an exemption.

ED/2011/4 *Investment Entities* is the joint response of the IASB and the FASB to that request. Although the Boards have conducted their consolidation projects jointly, there remains a key difference in the IASB and FASB proposals.

The ED proposes six criteria that an entity must meet to qualify as an investment entity.

In summary, the proposals would mean that:

- An investment entity would be exempt from consolidating the investments it controls. Instead, it would measure those investments at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*; or IAS 39 *Financial Instruments: Recognition and Measurement* where IFRS 9 has not yet been applied.
- An investment entity would be required to measure its investment property at fair value according to the fair value model in IAS 40 *Investment Property*.
- Under the IASB proposals (but not the FASB proposals), a parent of an investment entity would still be required to consolidate all subsidiaries that it controls, including those controlled by and measured at fair value in the investment entity. The parent entity would only be exempt from the consolidation requirement if it qualified as an investment entity itself.
- The proposals, if adopted, would be included in IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of interest in other entities*.

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed

ACCOUNTING IMPACT

May be significant.

The six proposed criteria

Whether an entity is an investment entity would be determined on the basis of an overall analysis of the nature of the entity's transactions and its relationship with its investees and external investors. The ED proposes six criteria that would all need to be met for an entity to qualify as an investment entity.

1. Nature of the investment activity. The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both.

An investment entity would be required not to have any significant assets or liabilities that do not relate to investment activities.

An exception would apply to investees that provide services that relate only to the investment entity's own investment activities (e.g. investment advisory services). Controlled investees providing such services would be consolidated by the investment entity.

Collateral (assets and related liabilities) controlled and held temporarily as a result of a default by an investee would not affect the status of an entity as an investment entity, provided the investee was not acquired with the intention of controlling the collateral.

Multiple investments could be held, whether directly or indirectly (e.g. through another investment). However, an investment entity would not be required to hold multiple investments at all times throughout its existence.

An entity would not be precluded from being an investment entity if it does not hold multiple investments in the following situations, provided it meets the other criteria:

- The entity's initial offering period has not expired.
- Suitable investments have not yet been identified and hence the investments plan has not been executed.
- Investments disposed of have not yet been replaced.
- The entity is in the process of liquidation.

Examples of an entity's activities being other than investing for the purpose of capital appreciation, investment income, or both (and, if substantive, failing the criteria for classification as an investment entity) would include:

- Acquiring, using, exchanging or exploiting intangibles or technologies from the investee or its affiliates.
- Joint arrangements between the investee or its affiliates and the entity or its affiliates. An affiliate is a party that directly, or indirectly through one or more intermediaries, controls or is controlled by the entity, or is a fellow subsidiary of the entity.
- Entering into arrangements between the investee or its affiliates and the entity or its affiliates to develop, produce, market or provide products or services.
- The investee or its affiliates enter into transactions that are unavailable to unrelated parties, that are not at a market price or that represent a significant part of one of the parties business. The boards decided to include this requirement as in the boards' views, this is what differentiates an investment entity from an operating conglomerate.

- The entity or its affiliates have disproportionate or exclusive rights to assets, technology, products or services of the investee or its affiliates.
- The investee or its affiliates provide financing guarantees or assets to serve as collateral for borrowing arrangements of the entity or its affiliates. However, an entity would still be able to use the investments in its investees as collateral of any of its borrowings.
- An affiliate of the entity holds an option to purchase from the entity ownership interests in an investee.

2. Business purpose. The entity makes an explicit commitment to a group of investors that the entity's purpose is investing to earn capital appreciation, investment income (such as dividends or interest), or both.

Evidence of the entity's express business purpose may be included in an offering memorandum, publications or other documents relating to the investment objectives or in the way the entity presents itself to other parties such as investors/investees. If an entity expresses a business purpose inconsistent with that of an investment entity it would not meet the requirements. Investment entities would have investment plans that include potential exit strategies to realise capital appreciation for all major investments.

3. Unit ownership. Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed.

Having multiple classes of equity investments in an entity would not preclude the parent entity from being an investment entity.

4. Pooling of funds. The funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent (if any), and collectively hold a significant ownership interest in the entity.

Investors that are considered to be related to the parent would be treated as a single investor. If the parent of the investment entity (or its related parties) had an arrangement to acquire additional interests those interests would be treated as if they were owned by the parent.

Having a single investor that is itself an investment entity and that was formed in conjunction with the entity, would not preclude the entity from being an investment entity if the other criteria are also met.

5. Fair value management. Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis.

This evaluation would be based on how the investment entity manages and evaluates performance, rather than on the nature of the investments. It would also look to whether fair value was used both internally (by management) and externally (by investors).

6. Providing Information. The entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity.

Disclosures

The ED sets a disclosure objective that an investment entity would provide information to enable users of its financial statements to evaluate the nature and financial effects of the investment activities in which it engages. The information could include:

- Detailed per-share information (e.g. fair value of net assets; net investment income/loss).
- Ratio of expenses and net investment income to average net assets.
- Total return including the methodology for computing.
- Committed funds of the owners and the ratio of total contributed funds to total committed funds.

The ED proposes specific disclosures in addition to those required by IFRS 7 *Financial Instruments: Disclosures*; IFRS 12 *Disclosure of Interest in Other Entities* and IFRS 13 *Fair Value Measurement*. These include:

- When an entity's status as an investment entity changes, the reasons for the change and where it becomes an investment entity the effects.
- Whether the investment entity has provided financial or other support to investees it controls, without having a contractual obligation to do so. Disclosures include type, amount and the reason for providing the support.
- Current intentions to provide financial or other support to investees it controls.
- Significant restrictions on the ability of controlled investees to transfer funds to the investment entity in the form of cash dividends, or repayment of loans or advances.

An investment entity would also disclose the investee's name, country of incorporation and the proportionate ownership held. An investment entity parent of another investment entity would also be required to provide this information for the investees that are controlled by its investment entity subsidiary.

Scope exclusion in IAS 28 (as amended in 2011)

The exemption in IAS 28 *Investments in Associates and Joint Ventures* that allows venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds to measure investments in associates and joint ventures at fair value through profit or loss would be removed. Instead the ED would amend IAS 28 to require an investment entity to measure its investments in associates and joint ventures at fair value through profit or loss.

The ED would only allow this exemption to investment entities. As a result all venture capital organisations, mutual funds, unit trusts and similar entities that did not qualify as an investment entity would have to apply equity accounting to their investments in associates and joint ventures.

Effective Date and Transition

The ED does not propose an effective date.

The finalised requirements of the ED would be applied prospectively by entities meeting the definition of an investment entity, with the effect of applying the requirements being recognised as an adjustment to retained earnings at the beginning of the period in which the new requirements were adopted for the first time.

Early adoption of the finalised requirements would be permitted provided that IFRS 10, IFRS 11, IFRS 12 and IAS 28 (as amended in 2011) were also applied.

Illustrative Examples – Replicated from ED/2011/04

Example 1

An entity, Limited Partnership, is formed in 20X1 as a limited partnership with a 10-year life. The offering memorandum provides that Limited Partnership's purpose is to invest in entities with rapid growth potential, with the objective of realising capital appreciation over its life. Entity GP (the general partner of Limited Partnership) provides 1 per cent of the capital to the Limited Partnership and has the responsibility of identifying suitable investments for the partnership. Approximately 75 limited partners, who are unrelated to each other, provide 99 per cent of the capital to the partnership.

Limited Partnership begins its investment activities in 20X1. However, no suitable investments are identified by the end of 20X1. In 20X2 Limited Partnership acquires a controlling interest in one entity, ABC Corporation. Limited Partnership is unable to close another investment transaction until 20X3, at which time it acquires equity interests in five additional operating companies. Other than acquiring these equity interests, Limited Partnership conducts no other activities. Limited Partnership manages its investments on a fair value basis and information about its investments is provided to Entity GP and the external investors on a fair value basis.

Limited Partnership has plans to dispose of its interests in each of its investees during the 10-year stated life of the partnership. Such disposals include the outright sale for cash of the equity interest, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities and the disposal of investments to the public or other unrelated entities.

Conclusion

Limited Partnership meets the definition of an investment entity from formation in 20X1 to 31 December 20X3. The following conditions exist:

- (a) Although Limited Partnership does not hold multiple investments until 20X3, during each of 20X1, 20X2 and 20X3 its express business plan is to hold multiple investments and it is actively pursuing investment opportunities during these periods.
- (b) Limited Partnership's only activity is acquiring equity interests in operating companies with the purpose of realising capital appreciation over the life of the investments. Limited Partnership has identified and documented an exit strategy for each investment.
- (c) Ownership in Limited Partnership is represented by units of partnership interests acquired through a capital contribution.
- (d) Limited Partnership is funded primarily by investors that are unrelated to each other and collectively hold 100 per cent of Limited Partnership. In addition, no party holds a controlling financial interest.
- (e) The investments are managed on a fair value basis.
- (f) Limited Partnership reports financial information about its activities to its investors.

Example 2

High Technology Fund was formed by six technology companies to invest in technology start-up companies for capital appreciation. In some circumstances, investors in High Technology Fund hold options to acquire investments held by High Technology Fund, at their fair value, if the technology developed by the investees would benefit the operations of the investors. No plans for exiting the investments have been identified by High Technology Fund. High Technology Fund is managed by an investment adviser that is otherwise not related to the investors.

Conclusion

Even though High Technology Fund's business purpose and investment activities are investing for capital appreciation and pooling of funds exists, High Technology Fund is not an investment entity because of the following arrangements and circumstances:

- (a) The investors of High Technology Fund hold options to acquire investments in investees held by High Technology Fund if the assets developed by the investees would benefit the operations of the investors. This provides a benefit in addition to capital appreciation, investment income (such as dividends and interest), or both.
- (b) The investment plans of High Technology Fund do not include exit strategies for its investments. The call rights held by investors are not controlled by High Technology Fund and do not constitute an exit strategy.

Example 3

Real Estate Partnership, a limited partnership with a 25-year life, was formed to own and operate retail properties. The general partner, Retail Property Company GP, initially has a 52 per cent interest in Real Estate Partnership. The limited partners include a number of unrelated investors, both individuals and companies. The limited partners do not have the right to replace or remove the general partner, except for cause (for example, fraud).

Retail Property Company GP has a controlling interest in Real Estate Partnership and is therefore an affiliate of Real Estate Partnership. Real Estate Partnership acquires land for development through contributions of properties from the general partner, Retail Property Company GP.

Retail Property Company GP's interest in Real Estate Partnership is increased on the basis of the value of the contributed properties. The properties are developed into retail centres through development agreements with Retail Property Company GP. After development, the properties are managed by Retail Property Company GP. Retail Property Company GP also develops, owns and operates other retail properties. Upon termination of Real Estate Partnership, the properties may be sold to third parties or Retail Property Company GP may acquire properties from Real Estate Partnership at values determined by independent appraisals.

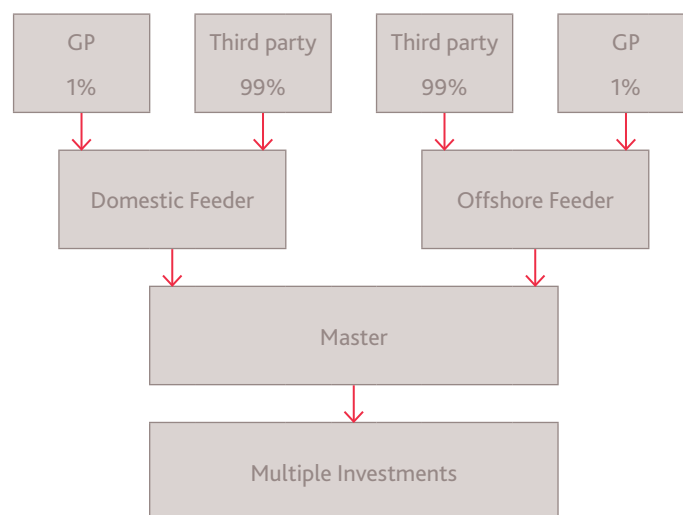
Conclusion

Real Estate Partnership does not meet the definition of an investment entity because of the following conditions:

- (a) The business purpose and activities of Real Estate Partnership includes developing retail properties. The nature of the partnership's activities would be considered to be other than investing for capital appreciation, investment income (dividends and interest), or both.
- (b) Retail Property Company GP obtains earnings from the properties held by Real Estate Partnership that are other than capital appreciation, investment income (such as dividends and interest), or both, because Retail Property Company GP is actively involved in the development and operation of the properties. Even though these transactions may be on terms that are available to entities that are not related parties of the investee (at a price that would be paid in an orderly transaction between market participants at the measurement date), the development and operations of the properties represent a significant portion of the investee's business activities.

Example 4

An entity, Master Fund, is formed in 20X1 with a 10-year life. The equity of Master Fund is held by two affiliated feeder funds. The feeder funds are established to meet legal, regulatory, tax or other requirements. The feeder funds are capitalised with a 1 per cent investment from the general partner and 99 per cent from unaffiliated investors (with no party holding a controlling financial interest).




The purpose of Master Fund is to hold multiple investments in order to generate capital appreciation and income (such as dividends or interest). The investment objective communicated to investors is that the purpose of the Master-Feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Master Fund has identified and documented exit strategies for the investments that it holds. In addition, investors receive periodic financial information, on a fair value basis, from the Feeder funds.

Conclusion

Master Fund and the Feeder funds each meets the definition of an investment entity. The following conditions exist:

- (a) The Master-Feeder structure's activities consist of holding multiple investments for capital appreciation and income (such as dividends or interest). Even though the sole investment held by the Feeder funds is their investment in Master Fund, the Feeder funds meet the multiple investments criteria because they were formed in conjunction with another investment entity, Master Fund, which holds multiple investments.
- (b) The Master-Feeder structure's business purpose, which was communicated directly to investors of the feeder funds, is investing for capital appreciation and income (such as dividends or interest). The Master-Feeder structure has identified and documented potential exit strategies for its investments.
- (c) Ownership in Master Fund and the Feeder funds is represented by units of equity.
- (d) Even though Master Fund is wholly capitalised by the Feeder funds, it was formed in conjunction with the Feeder funds, which are funded by investors who are unrelated to each other. In addition, no party holds a controlling financial interest in the Feeder funds.
- (e) The investments are managed on a fair value basis and information about the investments made by Master Fund is provided to investors on a fair value basis through the Feeder funds.
- (f) Master Fund and the Feeder funds are entities reporting financial information about their activities to their investors.



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