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Exposure Draft ED/2011/4

Investment Entities

Comments to be received by 5 January 2012

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Introduction and invitation to comment

Introduction

In December 2008 the International Accounting Standards Board published an exposure draft, ED 10 *Consolidated Financial Statements*, that proposed a revised definition of control as well as related application guidance and enhanced disclosures for consolidated and unconsolidated entities. ED 10 proposed that reporting entities should consolidate all controlled entities, regardless of the nature of the reporting entity. It did not propose to change the scope of the consolidation requirements of IAS 27 *Consolidated and Separate Financial Statements*. In the past, the Board had considered the needs of the users of financial statements regarding the consolidation of controlled investments by investment entities and concluded that their needs would not be well served if an investment entity did not consolidate the entities it controls. As a result, ED 10 did not debate this topic again.

However, many respondents to ED 10 questioned the usefulness of financial statements of investment entities if IFRSs continued to require the consolidation of entities that an investment entity controls. They asked the Board to reconsider whether investment entities should be exempted from consolidating investments in entities that are controlled. In response to that request the Board and the US national standard-setter, the Financial Accounting Standards Board (FASB), which had agreed to conduct their respective consolidation projects jointly, initiated a separate joint project to develop criteria to define an investment entity for the purpose of such an exemption. The Board decided that any resulting requirements would be included in IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*. However, for the convenience of the reader, the proposals in this exposure draft are presented as a self-contained issue rather than as amendments to IFRS 10 and IFRS 12.

This exposure draft proposes criteria for an entity to qualify as an investment entity and guidance for making this assessment. The proposals would require an investment entity to measure its investments in controlled entities at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* (as issued in October 2010) and to provide additional disclosures to enable users of its financial statements to evaluate the nature and financial effects of its investment activities.

This exposure draft also proposes that in its consolidated financial statements, a parent of an investment entity should not retain the fair value accounting that is applied by its investment entity subsidiary to controlled entities, unless the parent qualifies as an investment entity itself. As a consequence, a parent of an

investment entity should consolidate all entities it controls, including those that are controlled by an investment entity subsidiary, unless the parent is an investment entity itself. When consolidating, a parent of an investment entity would, however, retain the fair value accounting applied by the investment entity to investments in associates and joint ventures and other non-controlled entities.

For consistency within IFRSs the exposure draft also proposes to amend the relevant paragraphs of IAS 28 *Investments in Associates and Joint Ventures*:

- (a) to replace references to ‘venture capital organisation, mutual fund, unit trust and similar entities’ with ‘investment entity’; and
- (b) to require an investment entity to measure its investments in associates and joint ventures at fair value through profit or loss in accordance with IFRS 9.

To ensure comparability among entities, the exposure draft would require that entities applying this guidance early also apply all aspects of IFRS 10, IFRS 11 *Joint Arrangements*, IFRS 12 and IAS 28 (as amended in 2011).

Invitation to comment

The Board invites comments on all matters in this exposure draft and, in particular, on the questions set out in the following paragraphs. Respondents need not comment on all of the questions. Comments are most helpful if they:

- (a) respond to the questions as stated;
- (b) indicate the specific paragraph or paragraphs to which the comments relate;
- (c) contain a clear rationale; and
- (d) describe any alternatives the Board should consider.

The Board is not seeking comments on those aspects of IFRS 10, IFRS 11, IFRS 12, IAS 27 *Separate Financial Statements* and IAS 28 (as amended in 2011) not addressed in this exposure draft. The Board will consider all comments that it receives in writing by 23 December 2011.

Exclusion of investment entities from consolidation

The exposure draft proposes that an investment entity (as defined) should be required to measure investments in entities that it controls at fair value through profit or loss in accordance with IFRS 9 rather than consolidating such investments. Thus, the exposure draft proposes to create an exception to the principle of consolidation in IFRS 10 and thereby responds to the long-standing

concern raised by many, including users of financial statements, that the consolidation of investments in controlled entities by investment entities does not provide information as useful as the information that would be provided by measuring the investments at fair value through profit or loss.

Question 1

Do you agree that there is a class of entities, commonly thought of as an investment entity in nature, that should not consolidate controlled entities and instead measure them at fair value through profit or loss? Why or why not?

Criteria for determining when an entity is an investment entity (paragraphs 2 and B1–B17)

The Board believes that whether an entity is an investment entity should be determined on the basis of an overall consideration of the nature of the entity's transactions and its relationships with its investees and its external investors. To assist in determining whether an entity is an investment entity the exposure draft proposes criteria and application guidance that an entity must satisfy to qualify as an investment entity. Paragraph 2 states that an investment entity is an entity that meets all of the following criteria:

- (a) The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both [*nature of the investment activity*].
- (b) 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 [*business purpose*].
- (c) 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 [*unit ownership*].
- (d) 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 [*pooling of funds*].
- (e) Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis [*fair value management*].
- (f) 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.

Question 2

Do you agree that the criteria in this exposure draft are appropriate to identify entities that should be required to measure their investments in controlled entities at fair value through profit or loss? If not, what alternative criteria would you propose, and why are those criteria more appropriate?

‘Nature of the investment activity’ (paragraphs 2(a) and B1–B6)

The definition of an investment entity requires that the entity’s only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both. To meet this requirement, the entity should have no substantive activities other than its investing activities and it should not have any significant assets or liabilities other than those relating to investing activities, subject to the exceptions in paragraphs B2 and B3.

According to paragraph B2, if an entity provides (or holds an investment in an entity that provides) services that relate to investment activities (eg investment advisory services), the entity can still meet the substantive activities requirement if those services relate only to its own investment activities. If an investment entity controls an investee that provides these services, the investment entity should consolidate that investee.

Question 3

Should an entity still be eligible to qualify as an investment entity if it provides (or holds an investment in an entity that provides) services that relate to:

- (a) its own investment activities?
- (b) the investment activities of entities other than the reporting entity?

Why or why not?

‘Pooling of funds’ (paragraphs 2(d) and B14–B16)

When considering the criterion of pooled funds, the Board noted that a typical investment entity would have significant external investors who are not involved in the management of the entity. In addition the Board was concerned that in the absence of a criterion regarding pooling of funds an investment entity could be inserted into a larger corporate structure in order to achieve off balance sheet accounting for some assets, while the parent could own almost all of the

investment entity (see paragraph BC16). The exposure draft therefore proposes to require an investment entity to have unrelated investors who collectively hold significant ownership interests in the entity. Thus, on the basis of this criterion, a fund with a single investor unrelated to the fund manager, such as a sovereign wealth fund or separate financial statements of an insurance company, would not qualify as an investment entity.

Question 4

- (a) Should an entity with a single investor unrelated to the fund manager be eligible to qualify as an investment entity? Why or why not?
- (b) If yes, please describe any structures/examples that in your view should meet this criterion and how you would propose to address the concerns raised by the Board in paragraph BC16.

Measurement guidance (paragraphs 6 and 7)

The exposure draft proposes that the investment entity should measure its investments in entities that it controls at fair value through profit or loss in accordance with IFRS 9. It also proposes amendments to IAS 28, requiring an investment entity to measure investments in associates and joint ventures at fair value through profit or loss in accordance with IFRS 9. IAS 40 *Investment Property* permits an entity to measure at fair value property that qualifies as investment property. Paragraph B17 requires that the fair value model in IAS 40 be used by an entity that qualifies as an investment entity.

Question 5

Do you agree that investment entities that hold investment properties should be required to apply the fair value model in IAS 40, and do you agree that the measurement guidance otherwise proposed in the exposure draft need apply only to financial assets, as defined in IFRS 9 and IAS 39 *Financial Instruments: Recognition and Measurement*? Why or why not?

Accounting in the consolidated financial statements of a non-investment entity parent (paragraph 8)

Under the proposals the parent of an investment entity consolidates all entities it controls, including those controlled through an investment entity, unless the parent is itself an investment entity.

The Board thinks that in most cases, investment entities do not have non-investment entity parents. So, even if the proposed specialised accounting is restricted to situations where the parent is an investment entity, in most cases the investment entity accounting would be available when needed. However, the Board is concerned that if the non-investment entity parent of an investment entity followed the guidance proposed for investment entities when preparing consolidated financial statements there would be potential accounting inconsistencies and possibilities for abuse when accounting for an investment entity in the consolidated financial statements of a group that has a non-investment entity parent. For example, concerns were raised about the appropriate accounting if a non-investment entity parent were to issue its equity instruments to an investee of its investment entity subsidiary. In the absence of additional guidance, if the investment entity accounting were followed in the consolidated financial statements, the group would appear to have a stronger capital base although the additional equity is held within the group. The Board acknowledges that if more useful information is provided by requiring the investment entity subsidiary to measure controlled investees at fair value, it is likely that useful information would also be provided by retaining this accounting in the consolidated financial statements. On balance, the Board decided not to allow a non-investment entity parent of an investment entity to apply the requirements proposed in this exposure draft when preparing consolidated financial statements.

A reporting entity would, however, retain the proposed accounting by an investment entity that is an associate or a joint venture of the reporting entity. (So for example, when equity accounting an associate that is an investment entity, a reporting entity that is not an investment entity would include its proportionate share of an associate's profit or loss with the profit or loss measured in accordance with the proposals in the exposure draft).

Question 6

Do you agree that the parent of an investment entity that is not itself an investment entity should be required to consolidate all of its controlled entities including those it holds through subsidiaries that are investment entities? If not, why not and how would you propose to address the Board's concerns?

Disclosure (paragraphs 9 and 10)

The exposure draft proposes a disclosure objective that would require an investment entity to provide information to enable users of the financial statements to evaluate the nature and financial effect of the investment activities in which it engages. The exposure draft also proposes application guidance setting out information that may satisfy that disclosure objective (paragraphs B18–B20).

Question 7

- (a) Do you agree that it is appropriate to use this disclosure objective for investment entities rather than including additional specific disclosure requirements?
- (b) Do you agree with the proposed application guidance on information that could satisfy the disclosure objective? If not, why not and what would you propose instead?

Transition (paragraph C2)

The exposure draft proposes prospective application for entities that meet the definition of an investment entity.

Question 8

Do you agree with applying the proposals prospectively and the related proposed transition requirements? If not, why not? What transition requirements would you propose instead and why?

Scope exclusion in IAS 28 (as amended in 2011)

IAS 28 (as amended in 2011) allows venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds to irrevocably elect to measure investments in associates and joint ventures at fair value through profit or loss (IAS 28 paragraph 18).

The exposure draft proposes an amendment to IAS 28 to require investment entities, and only those entities, to measure their investments in associates and joint ventures at fair value through profit or loss. Furthermore the exposure draft would require entities that apply this guidance early to apply, in addition, IFRS 10, IFRS 11, IFRS 12 and IAS 28.

These decisions were made in order to align those IFRSs with the proposals in the exposure draft: each is intended to provide specialised accounting for entities commonly considered to be investment entities and to ensure comparability among entities that apply the guidance of this exposure draft.

In making the decision to require investment entities and only those entities to measure investments in associates and joint ventures at fair value, the IASB understood that the change should not result in a significant number of entities that currently qualify for the measurement exemption ceasing to qualify. However, the Board noted that it would be particularly helpful if respondents to the exposure draft provided information regarding the potential impact of this proposed amendment, including the scale of the impact.

Question 9

- (a) Do you agree that IAS 28 should be amended so that the mandatory measurement exemption would apply only to investment entities as defined in the exposure draft? If not, why not?
- (b) As an alternative, would you agree with an amendment to IAS 28 that would make the measurement exemption mandatory for investment entities as defined in the exposure draft and voluntary for other venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds? Why or why not?

Investment Entities

Objectives

- 1 The objectives of this [draft] IFRS are:
- (a) to specify the criteria for determining when an entity is an investment entity; and
 - (b) to specify how an investment entity shall account for its investments.

Determining when an entity is an investment entity

- 2 An investment entity is an entity that meets all of the following criteria:
- (a) The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both (see paragraphs B1–B6—nature of the investment activity).
 - (b) The entity makes an explicit commitment to its investors that the purpose of the entity is investing to earn capital appreciation, investment income (such as dividends or interest), or both (see paragraphs B7–B11—business purpose).
 - (c) 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 (see paragraphs B12 and B13—unit ownership).
 - (d) 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 in aggregate hold a significant ownership interest in the entity (see paragraphs B14–B16—pooling of funds).
 - (e) Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis (see paragraph B17—fair value management).
 - (f) 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 (see paragraphs B18–B20—disclosures).

Assessment

- 3 An entity shall determine whether it is an investment entity by considering the criteria as set out in this [draft] IFRS, and all facts and circumstances existing at the time. The entity shall reassess whether it meets the criteria for an investment entity if facts and circumstances indicate that there are changes to one or more of the criteria as set out in this [draft] IFRS.
- 4 An entity that no longer meets the definition of an investment entity shall account for the change in its status prospectively by accounting for its investments in accordance with other applicable IFRSs from the date when the change in status occurred. For those investees that are required to be consolidated because the entity no longer qualifies as an investment entity, the entity shall apply the requirements in IFRS 3 *Business Combinations*. The fair value of the investment at the date of the change in status shall be the investment's new carrying amount from that date.
- 5 An entity that becomes an investment entity within the scope of this [draft] IFRS shall disclose the effect of applying the [draft] IFRS from the date of the change in status. The effect of applying this [draft] IFRS from that date shall be recognised as an adjustment to opening retained earnings (in other comprehensive income) in the reporting period of the change in status. The adjustment to retained earnings represents the difference between (a) the carrying amount of the net assets of the entity's investees and (b) the fair value of the investees at the date of the change in status, plus any changes in the fair value of investees' net assets that had previously been recognised, and that remain in, accumulated other comprehensive income.

Measurement

- 6 **An investment entity shall not consolidate the entities that it controls. Instead, it shall measure those entities at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*.**
- 7 Exceptions to the requirement in paragraph 6 are the following:
- (a) If an investment entity controls an investee that provides services that relate only to the entity's own investment activities, it shall consolidate that investee (see paragraph B2);
 - (b) An investment entity that takes control of collateral as a result of defaults related to its investments (see paragraph B3), shall account for such assets (and related liabilities) in accordance with other applicable IFRSs.

- 8 A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity, unless the parent itself is an investment entity.

Disclosure

- 9 An investment entity shall provide information to enable users of its financial statements to evaluate the nature and financial effects of the investment activities in which it engages (see paragraphs B19 and B20).
- 10 In addition to disclosures required by IFRS 7 *Financial Instruments: Disclosures*, IFRS 12 *Disclosure of Interests in Other Entities* and IFRS 13 *Fair Value Measurement*, an investment entity shall disclose the following information:
- (a) When an entity's status has changed, as stated in paragraph 3, the entity shall disclose in the notes the change of status and reasons for the change. In addition, an entity that becomes an investment entity shall disclose the effect of the change of status on the financial statements for the period presented, including the effects of the change on the amounts of investments as of the date of the change of status and the related effects on profit or loss and total comprehensive income.
 - (b) Whether the investment entity has, during the reporting periods presented, provided financial or other support (explicitly or implicitly) to investees it controls, without having a contractual obligation to do so, including:
 - (i) the type and amount of support provided, including situations in which the investment entity assisted the investee in obtaining financial support, and
 - (ii) the reasons for providing the support.
 - (c) An investment entity shall disclose any current intentions to provide financial or other support to investees it controls, including intentions to assist a controlled investee in obtaining financial support.
 - (d) The nature and extent of any 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.

Appendix A Defined terms

This appendix is an integral part of the [draft] IFRS.

affiliate	An affiliate of an entity 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. Associates and jointly controlled entities are not affiliates.
control	is as defined in IFRS 10 <i>Consolidated Financial Statements</i> .

Appendix B

Application guidance

This appendix is an integral part of the [draft] IFRS.

Determining when an entity is an investment entity

Nature of the investment activity

- B1 The investment entity has no substantive activities other than its investing activities; consequently, the investment entity does not have significant assets or liabilities other than those relating to investing activities, subject to the exceptions in paragraphs B2 and B3.
- B2 If the investment entity provides (or holds an investment in an entity that provides) services that relate only to the investment entity's own investment activities (eg, investment advisory services), even if those activities were substantive, the entity could still meet the substantive activities requirement. If an investment entity controls an investee that provides these services, the investment entity shall consolidate that investee.
- B3 Investment entities sometimes make investments that are collateralised by assets unrelated to the investment objectives of the investment entity. If the investment entity controls collateral as a result of defaults related to the investees, holding such assets (and related liabilities) temporarily does not affect the status of the entity as an investment entity, provided that the investment entity did not acquire the investments with the intention of controlling the collateral. An entity shall consider all facts and circumstances, including the following, when assessing whether it holds the collateral temporarily:
- (a) the investment entity's general policies and past business practices with respect to holding collateral and being exposed to its risks.
 - (b) the investment entity's strategies about the sale of the particular collateral including the expected time frame to sell the collateral.
 - (c) the time that it is reasonable to expect would be needed to sell similar assets in current market conditions.
 - (d) the rights that a third party may have over the collateral.

Multiple investments

- B4 An investment entity is required to hold multiple investments directly at the same time, or to hold multiple investments indirectly at the same time through another investment entity. For example, an entity may hold multiple investments indirectly at the same time through another investment entity if the entity is formed (for legal, regulatory, tax or other business reasons) in conjunction with another investment entity that holds multiple investments.
- B5 Although the business purpose of an investment entity must be to hold multiple investments, an investment entity is not required to hold multiple investments at all times throughout its existence. For example, an entity is not precluded from being an investment entity in the following situations, provided it meets the other criteria of an investment entity:
- (a) The entity's initial offering period has not expired.
 - (b) The entity has not yet identified suitable investments and therefore has not yet executed its investment plan to acquire multiple investments.
 - (c) The entity has not yet made other investments to replace those it has disposed of.
 - (d) The entity is in the process of liquidation.

Earnings from investments

- B6 An entity's activities are considered to be other than investing for the purpose of capital appreciation, investment income (such as dividends or interest), or both, if the entity or its affiliates obtain, or have the objective of obtaining, benefits from its investments in any investee in which the benefits are not capital appreciation, investment income (such as dividends or interest), or both. Examples of relationships or activities that demonstrate that an entity is investing other than for capital appreciation, investment income (such as dividends or interest), or both, include but are not limited to the following:
- (a) The acquisition, use, exchange or exploitation of the processes, intangible assets or technology of the investee or its affiliates by the entity or its affiliates.
 - (b) Joint arrangements between the investee or its affiliates and the entity or its affiliates.

- (c) The investee or its affiliates and the entity or its affiliates enter into other arrangements to jointly develop, produce, market or provide products or services.
- (d) The investee or its affiliates and the entity or its affiliates enter into transactions that:
 - (i) are on terms that are unavailable to entities that are not related parties of the investee;
 - (ii) are not at a price that would be paid or received in an orderly transaction between market participants at the measurement date; or
 - (iii) represent a significant portion of the investee's or the entity's business activity, including business activities of affiliates of the investee or affiliates of the entity.
- (e) The entity or its affiliates have disproportionate rights, or exclusive rights, to purchase or otherwise acquire assets, technology, products or services of the investee or its affiliates; for example, if an entity or its affiliates hold an option to purchase an asset from an investee if the asset's development is deemed successful.
- (f) 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.)
- (g) An affiliate of the entity holds an option to purchase from the entity ownership interests in an investee.

Business purpose

- B7 The definition of an investment entity requires the entity to have made an explicit commitment to a group of investors or potential investors that the purpose of the entity is investing for capital appreciation, investment income (such as dividends or interest), or both. An entity that has an express business purpose that includes activities other than investing for capital appreciation, investment income (such as dividends or interest), or both, does not meet the definition of an investment entity.
- B8 Evidence of the entity's express business purpose may be included in the entity's offering memorandum, publications distributed by the entity and other corporate or partnership documents that indicate the investment objectives of the entity. Evidence of the entity's express business purpose may also include the manner in which the entity

presents itself to other parties (such as potential investors or potential investees); for example, an entity that presents its business as having the objective of investing for capital appreciation has an express business purpose that is consistent with the business purpose of an investment entity. Alternatively, an entity that presents itself as an investor whose objective is jointly developing, producing or marketing products with its investees has an express business purpose that is inconsistent with the business purpose of an investment entity.

- B9 An entity's express business purpose is also evidenced through its investment plans. Accordingly, an investment entity should have an exit strategy documenting how the entity plans to realise capital appreciation of its investments. For example, if an investment entity holds a majority interest in a private company investee, the investment entity would need to identify and document potential exit strategies to evidence the method through which it would realise its capital appreciation. However, for an investment in a minority interest of a publicly traded entity, it may be clear that the investment entity would realise the capital appreciation of its investments by disposing of the investment in the public market.
- B10 Although the investment entity may not yet have determined the specific method of disposing of an investment, the fact that the investment entity has identified potential exit strategies through which it would realise capital appreciation provides evidence that its express business purpose is consistent with the definition of an investment entity.
- B11 Exit strategies can vary by type of investment. For investments in private equity securities, examples of exit strategies include an initial public offering of equity securities, a private placement of equity securities, distributions (to investors) of ownership interests in investees (typically, in the form of marketable equity securities) and sales of assets (including the sale of an investee's assets followed by a liquidation of the investee). For investments in assets, such as real estate, an example of an exit strategy includes the sale of the real estate. For investments in debt securities, examples of exit strategies include selling the debt in a private placement, or converting the debt to equity securities and subsequently selling those equity securities. For investments in ownership interests traded in a public market, temporary cash equivalents, commodities and securities based on indices, examples of exit strategies include selling the investment in a private placement or in the market, if it is publicly traded.

Unit ownership

- B12 The definition of an investment entity requires that investors have acquired ownership units, such as shares or partnership interests, in the investment entity. Each unit of ownership represents a specifically identifiable portion of the net assets of the investment entity.
- B13 Having multiple classes of equity instruments, such as shares with preferential rights, does not preclude an entity from being an investment entity.

Pooling of funds

- B14 An investment entity sells its ownership interests to investors and invests the proceeds to achieve its investment objectives. To meet the definition of an investment entity, the entity must have investors that are unrelated to the entity's parent (if any), and they must in aggregate hold a significant ownership interest in the entity. Investors that are considered to be related to the parent shall be treated as a single investor for the purposes of applying this criterion.
- B15 If the parent (or its related parties) has an implicit or explicit arrangement to acquire another investor's ownership interests in the investment entity, those investments shall be combined and treated as if they were owned by the parent for the purposes of evaluating compliance with this criterion. Examples of when investments would be combined and treated as if they were owned by the parent include (a) the parent, or its related parties, hold an option to acquire another investor's ownership interests in the entity, or (b) the parent finances another investor's ownership interests and the ownership interests are collateral for the debt.
- B16 An entity with a single investor may be formed (for legal, regulatory, tax or other business reasons) in conjunction with the formation of the single investor entity. In some cases, the single investor entity may have its own investors that are unrelated to the single investor entity's parent (if any) and that, in aggregate, hold a significant ownership interest in the single investor entity. Provided that the entity meets all of the other criteria for an investment entity, 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 meeting the definition of an investment entity.

Fair value management

- B17 All controlled investments of an investment entity must be managed, and their performance evaluated, internally and externally, on a fair value basis. This evaluation is based on how the investment entity manages and evaluates performance, rather than on the nature of its investments. The entity's activities must demonstrate that the fair value is the primary measurement attribute used to make a decision about the financial performance of those assets. In order to meet this requirement, the entity would be required to account for its investment properties at fair value according to the fair value model in IAS 40 *Investment Property*.

Disclosures

- B18 An investment entity shall disclose the following for those investments that it controls:
- (a) the investee's name;
 - (b) the investee's country of incorporation or residence; and
 - (c) the proportionate ownership interest in the investee held by the investment entity and, if different, the proportion of voting interest held.

If the investment entity is the parent of another investment entity (the subsidiary) the parent shall also provide this disclosure for investments that are controlled by its subsidiary. The disclosure may be provided by including in the financial statements of the parent the financial statements of the subsidiary that contain the above information.

- B19 The following are examples of additional disclosures that may be appropriate to meet the disclosure objective in paragraph 10:
- (a) The following per-share information calculated on the basis of a share outstanding throughout each period presented:
 - (i) total assets less total liabilities on a fair value basis at the beginning of the period;
 - (ii) net investment income or loss per share. Net investment income or loss should be divided by the total number of shares outstanding at the reporting date. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable and may be disclosed in order to meet the disclosure objective.

- (iii) realised and unrealised gains and losses per share, which are balancing amounts necessary to reconcile the change in fair value per share with the other per-share information presented;
 - (iv) total income from investment operations, which is the sum of net investment income or loss and realised and unrealised gain or loss;
 - (v) distributions to shareholders;
 - (vi) purchase premiums, redemption fees or other capital items;
 - (vii) payments by affiliates (to reimburse the fund for a loss on a portfolio investment, or to reimburse the fund for a loss where a loss-making investment was purchased (typically by a fund adviser) that violated the fund's investment restrictions); and
 - (viii) total assets less total liabilities on a fair value basis at the end of the period.
- (b) Ratios of expenses and net investment income to average net assets, annualised for periods of less than a year, including the methodology for computing the ratios.
 - (c) Total return, including the methodology for computing the total return.
 - (d) An investment entity that obtains commitments from owners and periodically calls funds under those commitments to make investments discloses the total committed funds of the owners, the year of its formation and the ratio of total contributed funds to total committed funds of the owners.
- B20 To avoid unnecessary duplication of disclosures, it should be noted that an investment entity does not need to apply the disclosure requirements in this [draft] IFRS if other IFRSs require disclosure of the same information.

Appendix C

Effective date and transition

This appendix is an integral part of the [draft] IFRS.

Effective date

- C1 An entity shall apply this [draft] IFRS prospectively for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies this [draft] IFRS in its financial statements early, it shall also apply IFRS 10, IFRS 11, IFRS 12 and IAS 28 (as amended in 2011).

Transition

- C2 If an entity meets the definition of an investment entity, it shall report the effect of applying this [draft] IFRS as an adjustment to retained earnings as of the beginning of the period for which this [draft] IFRS is adopted for the first time. The adjustment to retained earnings represents the difference between (a) the carrying amount of the net assets of the entity's controlled investees and (b) the fair value of the investees at the date of first applying the [draft] IFRS, plus any changes in the fair value of investees' net assets previously recognised, and remaining in, accumulated other comprehensive income.

Application before applying IFRS 9

- C3 If an entity applies this [draft] IFRS but does not yet apply IFRS 9 *Financial Instruments*, any reference to IFRS 9 shall be read as a reference to IAS 39 *Financial Instruments: Recognition and Measurement*.

Appendix D

Amendments to other IFRSs

This appendix describes the amendments to other IFRSs that the Board expects to make when it finalises this proposed IFRS.

IFRS 10 Consolidated Financial Statements

The guidance proposed in this exposure draft will become part of IFRS 10 as follows:

- Amend paragraphs 2 and 18 and include a paragraph in the section 'Accounting requirements' before paragraph B81 so that the principles for the preparation and the presentation of consolidated financial statements apply only to a parent that is not an investment entity.

The following paragraphs will be moved to IFRS 10

From paragraph(s) or Appendix of Investment Entities	To paragraph(s), section or Appendix of IFRS 10
paragraph 2	After paragraph 17 (add a new section 'Determination of when an entity is an investment entity')
paragraphs 3-5	After paragraph 17 (add a new section 'Assessment of whether the entity is an investment entity').
paragraphs 6-8	After paragraph 25
Appendix A, definition: affiliate	Appendix A: Defined terms
Appendix B, paragraphs B1-B20	Appendix B, after paragraph B80 (include a new section 'Determining whether an entity is an investment entity')
Appendix C, paragraphs C1 and C2	Appendix C, after paragraph C3
Appendix D	Add a new Appendix after Appendix C

IFRS 12 *Disclosure of Interests in Other Entities*

The following paragraphs will be moved to IFRS 12

From paragraph(s) or Appendix of <i>Investment Entities</i>	To paragraph(s) or Appendix of IFRS 12
paragraphs 9 and 10	Paragraphs 19A and 19B
Appendix B, paragraphs B25 and B26	Appendix B, after paragraph B17

IAS 27 *Separate Financial Statements*

- Add 'investment entity' to the definitions.
- Amend paragraph 38 to require an investment entity that prepares separate financial statements to measure its investments in subsidiaries, jointly controlled entities and associates at fair value through profit or loss in accordance with IFRS 9.
- Add the following transition requirement:
 - An investment entity that prepares separate financial statements and accounts for its investments in subsidiaries, jointly controlled entities and associates at cost, shall measure those investments at fair value through profit or loss from the date this [draft] IFRS is first applied. The investor shall recognise any difference between the fair value of those investments on the date that this [draft] IFRS is first applied and the previous carrying amount of those investments as an adjustment to retained earnings at the beginning of the reporting period for which this [draft] IFRS is applied for the first time.

IAS 28 *Investments in Associates and Joint Ventures* **(as amended in 2011)**

- Replace any reference to 'venture capital organisations, mutual funds, unit trusts and similar entities' with 'investment entity'
- In the introduction of IAS 28 and in paragraph 13B, replace the measurement option with a measurement exception, requiring an investment-entity to measure its investments in associates or joint ventures at fair value through profit or loss in accordance with IFRS 9.

- Include a new paragraph in the introduction and add to the section 'Exemptions from applying the equity method' that a non-investment-entity parent of an investment entity shall retain the accounting that the investment entity subsidiary applies for its associates or joint ventures.
- Add the following transition provisions and add a paragraph that requires disclosure of the difference recognised in retained earnings as a result of the transition requirements:
 - An investor or joint venturer that is an investment entity that previously accounted for its direct investments in associates or joint ventures, using the equity method, shall measure those investments at fair value through profit or loss from the date this [draft] IFRS is first applied. The investor or joint venturer shall recognise any difference between the fair value of those investments on the date that this [draft] IFRS is first applied and the previous carrying amount of those investments as an adjustment to retained earnings at the beginning of the reporting period in which this [draft] IFRS is applied for the first time.
 - An investor or joint venturer that is not an investment entity, and that previously measured its direct investments in associates or joint ventures at fair value through profit or loss, shall consider the fair value of those investments from the date this [draft] IFRS is first applied to be the deemed cost of those investments and shall account prospectively for the investments in accordance with the equity method.
 - An investor or joint venturer that is not an investment entity and that previously accounted for its indirect investments in associates or joint ventures, or a portion of its indirect investments in associates or joint ventures, using the equity method, shall measure those investments, or the portion of it, at fair value from the date this [draft] IFRS is first applied if the entity holding those investments, or a portion of those investments, directly, is an investment entity. An investor or joint venturer shall recognise any difference between the fair value of those investments on the date that this [draft] IFRS is first applied and the previous carrying amount of those investments, plus any changes in the fair value of investees' net assets previously recognised in, and remaining in, accumulated other comprehensive income, as an adjustment to retained earnings at the beginning of the reporting period for which this [draft] IFRS is applied for the first time.

- An investment entity that previously accounted for its associates or its joint ventures using the equity method shall account prospectively for its associates or for its joint ventures at fair value through profit or loss in accordance with paragraph 13B. The non-investment entity shall adjust its equity method investment in the investment entity by recognising any difference between the fair value of the investment entity's associate or joint venture on the date that this [draft] IFRS is first applied and the previous carrying amount of that associate or joint venture, plus any changes in the fair value of investees' net assets previously recognised in, and remaining in, accumulated other comprehensive income, as an adjustment to parent's retained earnings at the beginning of the reporting period for which this [draft] IFRS is applied for the first time.

Illustrative examples

These examples accompany, but are not part of, the [draft] IFRS.

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.

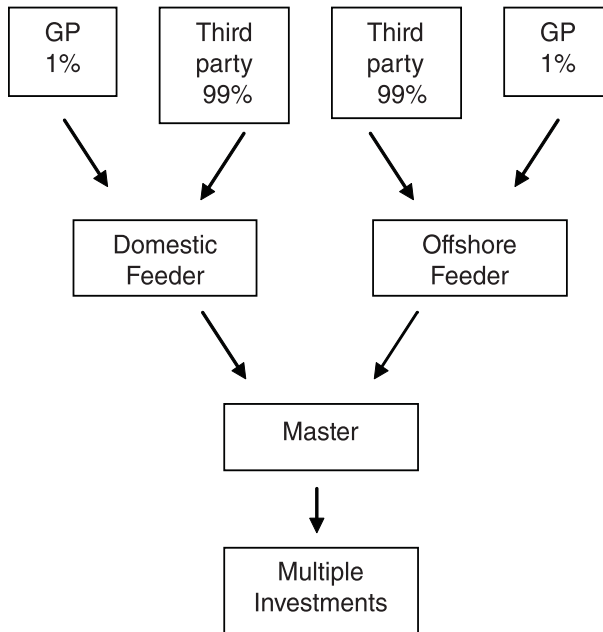
Conclusion

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.

Approval by the Board of *Investment Entities* published in August 2011

The exposure draft *Investment Entities* was approved for publication by twelve of the fifteen members of the International Accounting Standards Board. Sir David Tweedie, Mr McGregor and Mr Yamada voted against its publication. Their alternative views are set out after the Basis for Conclusions.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Elke König	
Patricia McConnell	
Warren J McGregor	
Paul Pacter	
Darrel Scott	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the exposure draft.

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board in reaching the conclusions in the exposure draft *Investment Entities*. Individual Board members gave greater weight to some factors than to others.

Proposals in *Investment Entities*

Scope

- BC2 In December 2008 the Board published an exposure draft, ED 10 *Consolidated Financial Statements*. The scope of the proposals was the same as that of IAS 27 *Consolidated and Separate Financial Statements*. IAS 27 required reporting entities to consolidate all controlled entities, regardless of the nature of the reporting entity. In 2005, during a revision of IAS 27, the Board considered the needs of users of financial statements regarding the consolidation of controlled investments by investment entities and concluded that users would not be well served if an investment entity did not consolidate entities that it controls. ED 10 did not debate this topic again. In general, the Board has always sought to avoid requirements that are industry-specific, focusing instead on the nature of transactions, rather than on the nature of the entities involved.
- BC3 However, respondents to ED 10 questioned the usefulness of financial statements of investment entities that consolidate entities that an investment entity controls. They pointed out that some other national accounting requirements, including US generally accepted accounting principles (GAAP), have historically had an exemption from consolidation that requires investment entities to measure at fair value investments that they control. The respondents argued that an investment entity holds investments for the purpose of capital appreciation, investment income (such as dividends or interest), or both. The investees held by an investment entity enhance its other assets, yet there is no recourse to the investment entity for the investee's debt, even if a controlling interest is held. Users of the financial statements of the investment entity told the Board that the most useful information is the fair value of the investment, and understanding how the investment entity measures the fair value of its investments.

- BC4 Furthermore, respondents to ED 10 argued that consolidated financial statements of an investment entity may impede users' ability to assess an investment entity's financial position and results because it emphasises the financial position, operations and cash flows of the investee, rather than those of the investment entity. To consolidate entities that are controlled by an investment entity may reduce the comparability of the different investments reported in an investment entity's financial statements. Commonly, an investment entity holds non-controlling interests in some entities that are reported at fair value, as well as controlling interests in other entities that are consolidated in accordance with current principles in IFRSs. Reporting investments on more than one basis hinders comparability within the financial statements, because all investments are held by an investment entity for a similar purpose—capital appreciation, investment income (such as dividends or interest), or both. In addition, some of the items consolidated would be measured at historical cost, which distorts the performance assessment of the investment entity and does not reflect the way the business of the entity is managed.
- BC5 In addition, respondents to ED 10 argued that when an investment entity consolidates entities that it controls, it is not required to provide the disclosures related to fair value measurements that would be required if the controlled investments were measured at fair value. For example, IFRS 7 *Financial Instruments: Disclosures* relates only to recognised financial assets and liabilities. There is no requirement to provide fair value related disclosures for items not recognised as such in the financial statements, which is the case for controlled investments that are consolidated. Information about the fair values themselves and the methodology and inputs used for developing fair value is vital for users to make investment decisions. Investors in an investment entity view themselves almost as investing directly in the investees of the investment entity. They view the investment entity as the manager of their investments. Consequently, they prefer to look through the investment entity to the investments themselves.
- BC6 The IASB considered this topic jointly with the US national standard setter, the Financial Accounting Standards Board (FASB), and acknowledged that consolidated information may not be the most useful information for these types of entities. Taking into account the comments received, as expressed in BC3–BC5 above, the boards decided that an entity that is considered an investment entity should be exempt from consolidating entities that it controls and should measure investments in such controlled entities at fair value through profit or loss.

- BC7 The boards acknowledge that they are creating an exception to the principle of consolidation by proposing that investment companies should measure at fair value investments in entities that they control. They therefore believe that it is essential to define carefully the appropriate population of entities that are required to use the exception. Accordingly, the boards propose criteria and application guidance to assist in determining whether an entity is an investment entity.

Definition

- BC8 The boards decided to use US GAAP as the basis for developing the criteria for an entity to be considered an investment entity. However, the boards identified some concerns about some aspects of the US guidance (Topic 946, *Financial Services—Investment Companies* in the *FASB Accounting Standards Codification*[®]) and decided that further analysis of the requirements was necessary to address those concerns. They also considered some of the guidance within Statement of Position (SOP) 07-1 *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, issued by the American Institute of Certified Public Accountants (AICPA) in June 2007. SOP 07-1 provides guidance for determining whether an entity is within the scope of Topic 946 and whether the specialised industry accounting principles are retained by a parent in consolidation or by an equity method investor. The SOP was deferred indefinitely with the publication of FASB Staff Position SOP 07-1-1 *Effective Date of AICPA Statement of Position 07-1*, in December 2007 because of concerns about some implementation issues.
- BC9 The boards believe that whether an entity is an investment entity should be determined on the basis of an overall consideration of the nature of the entity's transactions and relationships with investors. For the purpose of determining whether an entity is an investment entity, the boards propose guidance that considers the activities of the reporting entity, the relationships between the entity and investees, and the relationships between investors and the entity.

Investment activities

- BC10 The boards considered whether an investment entity's business activities should *primarily* be investing activities or whether *substantially all* of its activities should be investing activities. Topic 946 states that an investment entity's *primary* business activities involve investing in assets for capital appreciation, investment income (such as dividends or

interest), or both. The boards noted that ‘primary’ in US GAAP has been interpreted inconsistently with respect to the amount of non-investment activities that can be conducted by an investment entity. In order to clarify the intention behind the criterion, the boards decided that ‘substantially all’ was a preferable phrase to indicate that an investment entity should not have *substantive* activities other than its investing activities.

- BC11 The boards noted that an investment entity may sometimes hold an interest in an operating entity that provides support services for the investment entity’s investment activities. Such non-investing activities do not disqualify the entity from being an investment entity provided that they are performed solely to support the investing activities of the investment entity.
- BC12 The boards noted particular concerns for some venture capital investment companies. The boards were concerned that an entity that meets the definition of an investment entity could be inserted in a larger corporate structure in inappropriate circumstances to achieve a particular accounting outcome. For example, a larger parent entity could use an ‘internal’ investment entity subsidiary to invest in entities that may be making losses at the time (eg research and development activities on behalf of the overall group) and would record its investments at fair value, rather than reflecting the underlying activities of the investee.
- BC13 To address these concerns and to emphasise the business purpose of an investment entity, the boards decided to include a requirement that an investment entity and its affiliates should not obtain benefits from its investees that would be unavailable to other investors or to non-investors that are unrelated to the investee. In the boards’ view, this is what differentiates an investment entity from an operating conglomerate. If an entity or its affiliates obtains benefits from its investees that are unavailable to other investors, then the investment is designed to benefit the entity or its affiliates in some operating or strategic capacity and the entity is not an investment entity. For example, a parent entity could hold a fixed price call option to acquire the investments of the internal investment entity if the underlying investment is successful. In that situation, the purpose of the investment would no longer be for capital appreciation, investment income (such as dividends or interest), or both—the investment is designed to benefit the corporate entity in some operating or strategic capacity.

- BC14 The boards also decided that an entity should hold or plan to hold investments in multiple investees in order to qualify as an investment entity. Investment companies typically invest in multiple investees as a means of diversifying their portfolio and maximising their returns. Consequently, investing in multiple investees is an important characteristic of an entity that invests for capital appreciation, investment income (such as dividends or interest), or both. The boards considered whether specific guidance should be provided on the number of investments that an investment entity should hold. They concluded that it was unnecessary to provide a specific definition of multiple investments, but that it should be more than one investment (either directly or through another investment entity). The boards believe that entities will be able to apply judgement in determining whether the number of investments made by an entity is sufficient to lead to the conclusion that the entity is an investment entity.

Pooling of funds

- BC15 Noting US GAAP requirements in Topic 946 that require the funds of the investment entity's investors to be pooled in order to provide investors with professional investment management, the boards considered the nature and composition of the entity's investors and whether that should be a factor in determining whether the entity is an investment entity. They also considered whether there should be a requirement that an investment entity has a minimum number of investors or that a prescribed percentage of the investors should be passive investors. The boards did not propose such a requirement because they noted that an entity could be structured to meet this requirement by issuing equity to passive investors and, in turn, writing call and put options on these investments, so that their investments would be non-substantive. The boards also considered including guidance to determine whether a passive investment should be considered substantive. However, the boards concluded that this would complicate the investment entity criteria without improving them.
- BC16 The boards noted that a typical investment entity would have significant external investment and concluded that investors unrelated to the entity or its affiliates should collectively have significant ownership in the investment entity. The boards were concerned that an investment entity could be inserted into a larger corporate structure in order to achieve off balance sheet accounting for some assets, while the parent could own almost all of that investment entity. In addition, the criterion 'pooling of funds' could be met if the parent holds a call option on the investments

held by other investors. Because of this concern, the boards decided that interests held by related parties should be combined and treated as a single investor where one investor or its related parties have an implicit or explicit arrangement to acquire other investors' interests in the entity.

Exit strategy

- BC17 In developing the criteria for an investment entity, the boards decided that an investment exit strategy is essential to the business purpose of an investment entity. The boards believe that a parent with operating subsidiaries often plans to own and operate its subsidiaries indefinitely to realise returns from those operations. However, investment entities plan ultimately to dispose of their investments after earning an income stream, or by crystallising capital appreciation, or both. Although the exit strategy may vary depending on the nature and objectives of the investment, or on the maturity or development of the investee, or on market conditions or other circumstances, potential exit strategies should be identified and documented in order to meet the definition of an investment entity.

Entity that reports information to its investors

- BC18 US GAAP for investment companies contains a criterion that the reporting entity must be the primary reporting entity, though its intended meaning is unclear. The boards initially considered requiring an investment entity to be a separate legal entity. However, this requirement might exclude entities that would otherwise be considered investment entities (eg some trusts held by insurance entities do not have a separate legal status and some entities, such as partnerships, that are considered legal entities in one jurisdiction may not be considered legal entities in other jurisdictions). Accordingly, the boards decided that an investment entity can, but need not be, a separate legal entity. However, to qualify as an investment entity it must report financial information about its investing activities to its investors even if it is not a separate legal entity.

Parent of an investment entity

- BC19 The boards also considered including guidance for determining whether investment entity accounting should be retained in the financial statements of a non-investment-entity parent. Circumstances exist in which an entity may meet the definition of an investment entity on a stand-alone basis, but the entity's parent holds investments in the

investees of the investment entity (other than through its interest in the investment entity) for purposes other than capital appreciation, investment income (such as dividends or interest), or both. In addition, the boards were concerned that, without further guidance, circumstances might exist in which the accounting by the entity's parent could differ as a result of the parent selectively making investments within an investment entity subsidiary that are similar to investments held by non-investment-entity members of the consolidated group in order to avoid consolidation. The boards addressed this concern by precluding an entity from qualifying as an investment entity when the entity or its affiliates obtains or has the objective of obtaining returns (other than returns attributable to the ownership interest, such as dividends) from its investments in any investee that are unavailable to non-investor entities that are not related parties of the investee.

- BC20 The boards also considered whether a non-investment-entity parent of an investment entity should retain the fair value accounting of its investment entity subsidiary when preparing its consolidated financial statements. The boards discussed concerns about potential accounting inconsistencies and possibilities for abuse when accounting for an investment entity in the consolidated financial statements of a group. For example, they discussed the appropriate accounting if a non-investment-entity parent were to issue its equity to an investee of its investment entity subsidiary. In the absence of special guidance, if the investment entity accounting were retained in the consolidated financial statements, the group would appear to have a stronger capital base although the additional equity is held within the group. The IASB acknowledged that if more useful information is provided by allowing the investment entity subsidiary to measure controlled investments at fair value it is likely that useful information would also be provided by retaining this accounting in the consolidated financial statements. However, the boards expected that in most cases, investment entities would have investment entity parents. So, even if the application of the proposed accounting for investment entities is restricted to situations where the parent is an investment entity, in most cases the investment entity accounting would be available when needed. On balance, the boards decided not to allow a non-investment-entity parent of an investment entity to retain the proposed accounting for investment entities when preparing consolidated financial statements. All parents of investment entities would, however, retain the accounting its investment entity subsidiary applies for its associates or joint arrangements.

Disclosures

- BC21 Users told the boards that disclosures relating to the valuation methodology used for measuring fair value and the underlying inputs are essential to their analyses. This information is already required by IFRS 7 *Financial Instruments: Disclosures*, IFRS 13 *Fair Value Measurement* and Topic 820 *Fair Value Measurements and Disclosures* when reporting investments at fair value through profit or loss or other comprehensive income in accordance with IFRS 9 *Financial Instruments*/IAS 39 *Financial Instruments: Recognition and Measurement* or when reporting in accordance with US GAAP for investment companies in accordance with Topic 946. Accordingly, the boards decided that it was not necessary to propose any additional disclosure requirements relating to the fair value measurements made by investment entities.
- BC22 Consistently with the principles in IFRS 12, the boards decided to require an investment entity to disclose when any explicit or implicit financial support has been provided to entities that it controls. The boards concluded that it would help users of financial statements to understand an investment entity's exposure to risk.
- BC23 The boards decided that an investment entity should disclose the nature and extent of any significant restrictions (eg resulting from borrowing arrangements or regulatory requirements) on the ability of investees to transfer funds to the investment entity in the form of cash dividends, or repayment of loans or advances. The boards considered this requirement useful for investors because such restrictions could potentially affect distributions to investors of the investment entity's returns from investments.
- BC24 The boards considered requiring the disclosure of the most recently available summarised financial information for any individually material investment in an entity that an investment entity controls. However, they decided that because the investment entity exception from consolidation is based on their view that the most useful information for users is fair value information, requiring summarised financial information would be inconsistent with that decision. In addition, the boards reasoned that because users who supported the requirement to provide summarised financial information are primarily concerned with the concentration risk of the investment entity to any one investment, requiring a schedule of investments similar to the US requirement in Topic 946 would address this concern. However, the boards stressed that disclosures required for related party transactions would still apply.

- BC25 The boards discussed the inclusion of two additional disclosure requirements for IFRS users that are included in US GAAP for investment entities: a schedule of investments and a financial highlights schedule. The boards considered and agreed with comments from users currently receiving these disclosures that these disclosures are useful. However, because of the prescriptive nature of the US GAAP disclosures, the boards decided that it would be more useful to users to require disclosure of the nature and financial effects of the investment activities of the investment entities. The exposure draft includes examples of disclosures based on US GAAP that could be provided to meet the disclosure objective.

Transition

- BC26 The boards decided that the transition provisions should be applied prospectively because retrospective application would be impracticable. In addition, given the nature of an investment entity, retrospective application could involve hindsight over several years in order to determine what the fair value for multiple assets—some of which the entity may no longer hold—might have been. The boards thought that this application was too onerous, particularly as under IFRSs there was no previous requirement to disclose the fair values of such controlled investments. To propose retrospective application for investment entities would also be inconsistent with the tentative decisions taken by the boards for the overall consolidation standard.

Amendments to IAS 28 (as amended in 2011)

- BC27 IAS 28 *Investments in Associates and Joint Ventures* contains a measurement exemption for venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds. Such entities do not have to apply the equity method to investments over which they have significant influence or joint control if they elect to account for those investments in accordance with IFRS 9 or IAS 39 (as relevant) and measure them at fair value through profit or loss.
- BC28 The boards observed that the criteria developed in the exposure draft and the list of entities currently referred to in IAS 28 (as amended in 2011) have the same objective—to identify those entities for which fair value measurement of their investments provides more relevant information. Consequently, the boards decided (a) to propose replacing the list of entities referred to in the relevant paragraphs of IAS 28 (amended 2011) with the criteria for an investment entity proposed in the exposure draft and (b) to require an investment entity to measure investments in

associates and joint ventures at fair value through profit or loss in accordance with IFRS 9 and IAS 39. In the boards' view, the proposed amendment will increase consistency within IFRSs by applying the same criteria for identifying an investment entity and requiring the same measurement for all investments of an investment entity. The boards noted that the proposal would align IFRSs more closely with US GAAP, which contains the same measurement requirements for all investments of an investment entity, regardless of whether the investment entity has control, joint control or significant influence over the investee.

- BC29 The boards acknowledge that the proposed amendment to IAS 28 (as amended 2011) might cause fewer entities to be able to measure their investments in joint ventures and associates at fair value through profit or loss, even though in its view this measurement might produce, for some of those entities, more relevant information to users of financial statements than measuring the investments by the equity method.

Benefits and costs

- BC30 The objective of financial reporting is to provide information that is useful to existing and potential investors, creditors, donors and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Existing and potential investors, creditors, donors and other users of financial information benefit from improvements in financial reporting, while the costs of implementing new guidance are borne primarily by existing investors. The boards' assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative, because there is no method for measuring objectively the costs of implementing new guidance or to quantify the value of improved information in financial statements.
- BC31 The boards believe that the addition of a definition and measurement guidance for investment entities is an improvement to IFRSs. Requiring fair value measurement for controlled investments of investment entities will assist users in their analyses of these entities and will lower costs to preparers as investment entities already operate on a fair value basis.

Early application

BC32 The Board decided to permit early application of any finalised requirements resulting from the exposure draft. The exposure draft proposes that if an entity elects to apply early any finalised requirements that result from these proposals, the entity must also apply all of IFRS 10, as well as IFRS 11, IFRS 12 and IAS 28 (as amended 2011) that it does not already apply. The Board is concerned that if an entity were permitted to apply the finalised guidance of this exposure draft early without also applying IFRS 10, IFRS 11, IFRS 12 and IAS 28 (as amended 2011), there would be a period of significant incomparability among entities until all those standards are mandatorily effective. That is because there will be many possible combinations of requirements that are adopted early and those that are not. However, the final decision in respect to effective date and transition will depend on the responses the Board receives to this exposure draft.

Alternative Views of Warren J McGregor, Sir David Tweedie and Tatsumi Yamada

- AV1 Mr McGregor, Sir David Tweedie and Mr Yamada voted against publication of the exposure draft *Investment Entities*. Paragraphs AV1–AV12 set out their alternative views. Paragraphs AV13 and AV14 describe a further issue that Mr Yamada wished to raise. Messrs McGregor and Yamada and Sir David disagree with the proposal in the exposure draft to introduce an exception to the principle of consolidation. They believe that the proposal would result in the presentation of financial statements by investment entities that are less relevant and less representationally faithful than would be the case if controlled investees were consolidated.
- AV2 Those three Board members believe that the concept of control is fundamental to the preparation and presentation of financial statements. The *Conceptual Framework* identifies control as an essential characteristic of an asset and, in turn, defines the other elements of the financial statements by reference to the definition of an asset. Although not articulated explicitly in the *Conceptual Framework*, the concept of control is, in effect, central to determining the boundaries of a reporting entity. This is reflected in the provisions of existing IFRSs: entities are required to recognise in their financial statements assets that they control directly and assets (and related claims) that they control indirectly by controlling other entities that in turn control those assets directly.
- AV3 The Board's project on the *Conceptual Framework* includes a proposed chapter on the reporting entity. In March 2010 the Board (together with the US national standard-setter, the Financial Accounting Standards Board) published an exposure draft *Conceptual Framework for Financial Reporting: The Reporting Entity*. In that exposure draft, the Board proposed to make explicit that the concept of control is central to determining the boundaries of a reporting entity and explains why the presentation of financial statements on that basis provides relevant information to users of financial statements. Paragraph RE8 states:

If one entity controls another entity, the cash flows and other benefits flowing from the controlling entity to its equity investors, lenders and other creditors often depend significantly on the cash flows and other benefits obtained from the entities it controls, which in turn depend on those entities' activities and the controlling entity's direction of those activities. Accordingly, if an entity that controls one or more entities prepares financial reports, it should present consolidated financial statements. Consolidated financial statements are most likely to provide useful information to the greatest number of users.

Mr McGregor, Sir David and Mr Yamada agree with this rationale.

- AV4 Paragraphs BC3–BC6 of the Basis for Conclusions on the exposure draft *Investment Entities* contain the Board’s justification for proposing an exception to the principle of consolidation. Mr McGregor, Sir David and Mr Yamada do not find the arguments persuasive.
- AV5 In paragraph BC3, the Board states that users of the financial statements of investment entities have said that the most useful information about investments in controlled entities is the fair value of the investments and an understanding of how the investment entity measures those fair values. Mr McGregor, Sir David and Mr Yamada acknowledge those views but believe that the needs of users of financial statements would be better served by consolidating controlled investees and either disclosing the fair value information in the notes to the financial statements or providing separate financial statements for the parent entity showing all controlled investees at fair value. In that way, users of financial statements would be provided with information not only about the fair value of the reporting entity’s investments in controlled investees but also about the activities of controlled investees. As the Board observed in the exposure draft on the reporting entity (see paragraph AV3), when an entity controls another entity, the cash flows and other benefits flowing from the controlling entity to its equity investors, lenders and other creditors often depend significantly on the cash flows and other benefits obtained from the entity it controls, which in turn depend on that entity’s activities and the controlling entity’s direction of those activities.
- AV6 In paragraph BC4, the Board observes that some respondents to ED 10 *Consolidated Financial Statements* said that consolidated financial statements obscure users’ ability to assess the investment entity’s financial position and results of operations because such financial statements emphasise the financial position, operations and cash flows of the investee, rather than those of the investment entity. Mr McGregor, Sir David and Mr Yamada acknowledge that consolidated financial statements present the financial position, results of operations and cash flows of the controlling and controlled entities in combination, but believe that this better reflects the economic effects of the relationships between the entities. They believe that this perspective provides relevant information to users of financial statements for estimating the amount, timing and uncertainty of future cash flows. Moreover, as noted in paragraph AV5, presenting supplementary fair value information about investments in controlled investees in either the notes to the consolidated financial statements or in parent company financial statements would provide users with an alternative perspective without resorting to an exception to the consolidation principle.

AV7 In paragraph BC4, the Board observes that users also stated that consolidating controlled investees could reduce the comparability of the different investments presented in an investment entity's financial statements, because although investments in all investees are held for a similar purpose, investments in non-controlled investees would commonly be presented at fair value and investments in controlled investees would be consolidated. Mr McGregor, Sir David and Mr Yamada note that comparability is defined in Chapter 3 paragraph QC21 of the *Conceptual Framework* as the qualitative characteristic of useful financial information that enables users to identify and understand similarities in, and differences among, items. Paragraph QC23 states:

... For information to be comparable, like things must look alike and different things must look different. ... Comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.

Mr McGregor, Sir David and Mr Yamada believe that measuring investments in controlled investees at fair value would impair the comparability of the reporting entity's financial statements by making unlike things look alike. In their view, a controlling interest in another entity is not the same as a non-controlling interest in another entity, because the reporting entity has the power to direct the activities of the controlled entity for its benefit. Reporting requirements should reflect this difference. Furthermore, investments in controlled investees that are in significantly different financial positions will appear to be alike if they are all measured at fair value. Those three Board members believe that an investment in a controlled investee with a fair value of CU1 million and assets of CU9 million and liabilities of CU8 million is different from an investment in a controlled entity with a fair value of CU1 million and assets of CU900 million and liabilities of CU899 million. Financial reporting requirements should also reflect this difference.

AV8 In paragraph BC5, the Board observes that when an investment entity consolidates investees that it controls, it is not required to provide the disclosures related to fair value measurements that would be required if the investments were measured at fair value and, as a result, users are deprived of vital information. Mr McGregor, Sir David and Mr Yamada agree with this observation but believe that this information deficiency would be better rectified by separately requiring disclosure of the information either in the notes to the consolidated financial statements or in parent company financial statements showing controlled investees at fair value. In their view, addressing this deficiency by introducing an exception to the consolidation principle deprives users of other relevant information about controlled investees.

- AV9 In paragraph BC7, the Board acknowledges that it is proposing an exception to the consolidation principle and states that it is therefore essential that the appropriate population of entities is able to use the exception. To achieve this outcome the Board proposes criteria and application guidance to assist in determining whether an entity is an investment entity.
- AV10 Mr McGregor, Sir David and Mr Yamada believe that financial reporting requirements should be principle-based and contain few, if any, exceptions. They observe that when exceptions are permitted the Board spends a great deal of time and effort in ring-fencing the exception. This results in the inclusion in a standard of detailed rules that are often subject to review as entities test the boundaries of the exception.
- AV11 Those three Board members believe that significant pressure will be placed on the definition of investment entities as entities seek to avoid the cost and effort involved in consolidation and/or seek to avoid revealing the underlying financial position of controlled investees. In this regard, they are concerned that the criteria for determining whether an entity is an investment entity as set out in the exposure draft are highly subjective and open to abuse. In particular, they observe that the criteria in paragraphs B1, B3 and B5 contain ill-defined terms that are open to wide interpretation.
- AV12 Mr McGregor, Sir David and Mr Yamada are concerned that this will result in a reduction in the quality of financial reporting about investments in controlled investees as entities endeavour to exploit the exception. They are also concerned that the Board and its Interpretations Committee will be required to expend considerable resources on maintaining the exception.
- AV13 Mr Yamada does not agree with the combination of the requirements of paragraphs 6 and 8. Paragraph 6 requires an investment entity, including an investment entity subsidiary, to measure the entities that it controls at fair value through profit or loss. Paragraph 8 requires a non-investment-entity parent to consolidate all entities it controls, including those controlled through an investment-entity subsidiary. He thinks that it would be unduly burdensome to require an investment-entity subsidiary to account for its controlled investees at fair value through profit or loss in addition to those same entities being consolidated by the non-investment-entity parent. He thinks that if the non-investment-entity parent is required to consolidate the investment entity subsidiary

and that subsidiary's controlled investees, the investment entity subsidiary should not be required to account for its investments in controlled entities at fair value through profit or loss as set out in paragraph 6.

- AV14 Mr Yamada also disagrees with the requirements in paragraph 8 that investment entities should account for their controlled investees at fair value through profit or loss in the separate financial statements. He thinks that investment entities should be permitted the choice of accounting for their controlled investees at cost or at fair value through profit or loss.