The costs and benefits of implementing the Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)* ('the Amendments').

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. The results of the consultations that EFRAG has carried out seem to confirm this. Therefore, as explained more fully in the main sections of this report, the approach that EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendments in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A SUMMARY OF THE AMENDMENTS

What has changed?

4 The Amendments to IFRS 10 introduce a requirement for investment entities to measure their investments in particular subsidiaries at fair value through profit or loss, instead of consolidating them.

5 The scope of the IAS Regulation is based on the Seventh Accounting Directive and does not depend on whether IFRSs require consolidation or not. Therefore, an entity would not be able to avoid applying IFRSs because of the investment entities requirements set out in the Amendments.

6 The main changes introduced by the Amendments are:

(a) *Definition of an investment entity* – The Amendments provide a definition of an investment entity and guidance on the typical characteristics displayed by an investment entity, which an entity should consider when determining whether it qualifies as an investment entity.

(b) *Exception to consolidation* – Entities that meet the definition of an investment entity will not consolidate their investments in subsidiaries. However, this exception does not apply in the following cases:

  (i) an investment entity is still required to consolidate a subsidiary that provides services that relate to the investment entity's activities; and

  (ii) a parent of an investment entity, that is itself not an investment entity, is still required to consolidate all its investments in subsidiaries, meaning that consolidation is still required but at a higher level. This is sometimes referred to as the prohibition of the "roll-up".

(c) *Measurement at fair value* – An investment entity is required to measure its investments in subsidiaries at fair value through profit loss in accordance with IFRS 9 *Financial Instruments*.

(d) *Specific disclosure requirements* – IFRS 12 *Disclosure of Interests in Other Entities* requires specific disclosures about subsidiaries that are not consolidated because they are investments of an investment entity. The same disclosure requirements apply in the separate financial statements of an investment entity.

(e) *Separate financial statements of investment entities* – The Amendments remove the measurement option in IAS 27 *Consolidated and Separate Financial Statements* for investments in particular subsidiaries, and require entities that meet the definition of an investment entity to measure those particular subsidiaries in the same way as in the consolidated accounts (i.e. at fair value through profit or loss).

  The option to measure investments in subsidiaries at cost or at fair value under existing IAS 27 would still be available for parent entities that do not meet the definition of an investment entity and for the subsidiaries of investment entities that will be required to be consolidated by an investment entity (e.g. a subsidiary that provides services that relate to the investment entity's investment activities).

(f) *Consequential changes to other IFRSs* – The Amendments align the consolidation exception and the requirement to measure investments in subsidiaries at fair value with existing IFRS requirements. The main consequential changes include the requirement for a first-time adopter of IFRS (that is a parent) to assess whether it is an investment entity – on the basis of the facts and circumstances that exist at the date of transition to IFRSs; and in a separate change to state that the requirements of IFRS 3 *Business Combinations* do not apply to the acquisition by an investment entity.

Definition and typical characteristics displayed by an investment entity

7 The Amendments define an investment entity as an entity that has the following three essential elements:

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

(b) it commits to its investor(s) that its business purpose is investing funds solely for returns from capital appreciation, investment income, or both; and

(c) it measures and evaluates the performance of substantially all of its investments on a fair value basis.

8 In addition, when assessing whether it meets the above definition, an entity should also consider whether it has the following typical characteristics to qualify as an investment entity (although their absence does not preclude classification as an investment entity):

(a) it has more than one investment;

(b) it has more than one investor;

(c) it has investors that are not related parties of the entity; and/or

(d) it has ownership interests in the form of equity or similar interests.

9 If an entity does not have any of the above typical characteristics it is not necessarily disqualified from being an investment entity. In those situations, an entity would need to apply addition judgement to determine whether it is an investment entity and disclose the reasons for concluding that it still meets the definition of an investment entity.

10 The Amendments require any changes to the investment entity status to be accounted prospectively from the date at which the change in status occurred and apply IFRS 3 to any subsidiary that was previously measured at fair value through profit or loss. Similarly, an investment entity will cease to consolidate its investments in subsidiaries at the date of the change in status.

Amendments to IFRS 12

11 In developing the Amendments, the IASB considered that investment entities would be required to make disclosures already contained in other IFRSs, namely IFRS 7 *Financial Instruments: Disclosures* and IFRS 13 *Fair Value Measurement.*

12 Accordingly, the Amendments do not require additional disclosure requirements relating to fair value measurement. Furthermore, they focus on disclosures in IFRS 12 that are specific for investments entities (including investment entities that are parents of other investment entities).

13 Specifically, the Amendments require the following disclosure under IFRS 12:

(a) significant judgements and assumptions in determining that it meets the definition of an investment entity, including the reasons for concluding that it is an investment entity if it does not have one or more of the typical characteristics of an investment entity;

(b) the change in investment entity status and the reasons for the change including the effect of the change of status on the financial statements for the period presented;

(c) the nature and extent of any significant restrictions on the ability of an unconsolidated subsidiary to transfer funds to the investment entity and any current commitments or intentions to provide financial or other support to the investment entity;

(d) current commitments or intentions to provide financial support or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support;

(e) in case financial support is provided, without a contractual obligation to do so, the type and amount of the support provided to an unconsolidated subsidiary without a contractual obligation to do so, and the reasons for that;

(f) the terms of any contractual arrangements that could require an investment entity or its unconsolidated subsidiaries to provide support to a structured entity including events and circumstances that could expose the entity to a loss.

Transitional provisions

14 Entities are required to apply the Amendments retrospectively, with some transitional relief, consistent with the transition requirements in IFRS 10 as amended in June 2012. Specifically, the Amendments:

(a) clarify that the assessment of whether an entity meets the definition of an investment entity is only required at the date of initial application of these Amendments;

(b) allow an impracticability exception to identify retrospectively fair value for all controlled investees;

(c) allow investment entities to retain the previous accounting instead of applying the investment entity requirements for investments in subsidiaries that were disposed of before the date of initial application of the Amendments;

(d) permit an entity to restate only the annual period immediately preceding the date of initial application of the Amendments; and

(e) allow investment entities that elect to apply the consolidation exception retrospectively for any period prior to the effective date of IFRS 13, to retain the fair value amounts that were previously reported to investors or to management, provided they meet certain conditions.

15 The transition relief described above is also applicable when an investment entity applies the Amendments in its separate financial statements.

Who is affected by the Amendments?

16 The entities mostly likely to be affected by the Amendments are private equity or venture capital funds who may have a business model in which they take a controlling interest in an entity they investment in, or control entities through debt and equity investment.

17 The Amendments will also affect master-feeder and funds-of-funds structures and sovereign wealth funds and other types of investment funds, when they meet the definition of an investment entity and hold controlling investments in other entities.

When do the Amendments become effective?

18 The Amendments will apply retrospectively and become effective for annual periods beginning on or after 1 January 2014, with earlier application permitted. Early adopters would need to disclose that fact and apply all the amendments at the same time.

EFRAG's initial analysis of the costs and benefits of the Amendments

19 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendments, both in year one and in subsequent years. The results of EFRAG's initial assessment can be summarised as follows:

(a) *Costs* – The Amendments would result in significant cost savings for investment entity preparers and users of the financial statements of investment entities.

(b) *Benefits* – The benefits to be derived from implementing the Amendments in the EU are likely to outweigh the costs involved.

20 EFRAG published its initial assessment and supporting analysis on 20 December 2012. It invited comments on the material by 28 January 2012. In response, EFRAG received nine comment letters. Five respondents agreed with EFRAG's assessment of the benefits of implementing the Amendments and the associated costs involved for users and preparers. One respondent did not comment specifically on EFRAG's initial assessment of the costs of implementing the Amendments, but agreed with EFRAG's assessment of the benefits of implementing the Amendments and supported EFRAG's recommendation that the Amendments be adopted for use in Europe. One respondent did not agree with EFRAG's initial assessment of the technical criteria for endorsement but agreed with EFRAG's assessment of the benefits of implementing the Amendments and the associated costs involved for users and preparers. Two respondents did not comment specifically on EFRAG's initial assessment of the costs and benefits of implementing the Amendments in the EU, but supported EFRAG's recommendation that the Amendments be adopted for use in Europe.

EFRAG's final analysis of the costs and benefits of the Amendments

21 Based on its initial analysis and stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of the Amendments is presented in the paragraphs below.

Cost and benefits for preparers

22 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments on investment entities.

23 EFRAG understands that investment entities (preparers) might incur some initial costs in order to identify and document some of the new disclosures introduced in IFRS 12, IFRS 7 and IFRS 13. However, we believe that investment entities will already have most of the fair value information that they need in order to comply with the requirements, because they already measure substantially all of their investments at fair value and many will most likely already provide this information to users. Therefore, we do not expect the initial and ongoing costs in relation to the additional disclosure requirements to be significant.

24 On an ongoing basis, EFRAG believes that the Amendments will result in significant cost savings for investment entities (preparers), because they will no longer need to perform the consolidation procedures and account for the underlying net assets of their subsidiaries on a line-by-line basis.

25 The Amendments will facilitate preparers in communication with users in better understanding the fair values of the investments of investment entities, and therefore benefit preparers.

26 Entities are required to apply the Amendments retrospectively, with some transitional relief, consistent with the transition requirements in IFRS 10 as amended in June 2012. EFRAG notes that the Amendments would allow an impracticability exception to identify retrospectively fair value for all controlled investees, and therefore should reduce the burden for affected preparers on initial application.

27 EFRAG acknowledges that a non-investment entity parent will not be permitted to retain the fair value accounting applied by its investment entity subsidiaries. Therefore these entities might incur some ongoing costs by having two different measurement bases of accounting within the group. However, we understand that the Amendments do not change the consolidation requirements for these entities; therefore we do not expect these costs to be significant.

<u>Separate financial statements</u>

28 In addition, the Amendments will require the investments of an investment entity to be accounted for in the separate financial statements in the same manner as they are accounted for in the consolidated financial statements – at fair value through profit and loss under IFRS 9.

29 As explained above, we believe that most investment entities will already have most of the fair value information that they need in order to comply with the requirements, because they already measure substantially all of their investments at fair value to qualify as an investment entity. Therefore, we do not expect the initial and ongoing costs in relation to the additional disclosure requirements to be significant.

Cost and benefits for users

30 EFRAG has carried out an assessment of the cost and benefit implications for users resulting from the Amendments.

31 EFRAG notes that the Amendments have been developed at the request from users, and will provide them with information about the fair value of an investment entity's investments in subsidiaries and the way in which the fair value is measured. This information should reduce the cost of analysis for users, and improve the comparability and relevance of information provided to them.

32 We understand that the transition relief on the retrospective application of the exception to consolidation might result in less information for users on initial adoption. In particular, we note that the relief to provide comparative information only for one period might result in increased one off costs for users.

<u>Separate financial statements</u>

33 EFRAG believes that users will also benefit from having a consistent measurement basis at fair value for investments in subsidiaries of investment entities, in their separate financial statements.

Conclusion

34 On balance, EFRAG's assessment is that overall the cost savings from implementing the Amendments are expected to be significant for investment entity preparers and the users of their financial statements.

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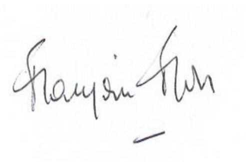

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