IFRS 10 Consolidated Financial Statements
Exception to Consolidation for Investment Entities

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Purpose and Scope

IFRS 10*, Consolidated Financial Statements*, contains an exemption from consolidation for entities that meet the definition of an investment entity. The exemption was implemented to reflect the different business model that investment entities are based on compared to other entities. For example, investment entities manage all of its investments on a fair value basis; therefore, providing fair value information is more useful for its investors than providing consolidated financial statements.

This guide will assist users in determining whether an entity meets the exemption criteria by providing the definition criteria and typical characteristics of investment entities. If it is determined an entity meets the exemption criteria, the guide will discuss accounting treatment and the required disclosures.

The exemption to consolidation in IFRS 10 is applicable for periods beginning on or after January 1, 2014. The amendment should be applied retrospectively.

We have provided a guide below summarizing the key factors of the exemption to consolidation contained in IFRS 10. Please note, that this guide should be used in conjunction and consideration of the complete IFRS 10 standard.

Definitions

Consolidated financial statements: The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Control of an investee: An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Decision maker: An entity with decision-making rights that is either a principal or an agent for other parties.

Group: A parent and its subsidiaries.

Investment entity: An entity that:

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

Parent: An entity that controls one or more entities

Power: Existing rights that give the current ability to direct the relevant activities.

Relevant activities: For the purpose of this IFRS, relevant activities are activities of the investee that significantly affect the investee's returns.

Subsidiary: An entity that is controlled by another entity.

Identifying an investment entity

The first step in applying the exemption in IFRS 10, is to assess whether the entity meets the investment entity definition.

IFRS 10.27 states that a parent shall determine whether it is an investment entity. An investment entity is an entity that:

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

In order for an entity to qualify as an investment entity, it must meet the definition noted above. The following characteristics must also be considered.

Characteristics of an investment entity

IFRS 10.28 provides the following characteristics of an investment entity:

1. It has more than one investment;
2. It has more than one investor;
3. It has investors that are not its related parties
4. It has ownership interests in the form of equity or similar interests

The above characteristics support the entity in assessing whether the definition of an investment entity is met. If one or more of the above characteristics is not present it does not necessarily mean the entity is not an investment entity; however, additional disclosures as stated in IFRS 12.9A are required to support the conclusion that the entity is an investment entity.

Determining whether an entity is an investment entity

When determining whether an entity is an investment entity, we must consider all the facts and circumstances relevant to each scenario. The definition of investment entity has four key elements that we must consider that will be described in more detail in this section as follows:

1. Business purpose;
2. Exit strategies;
3. Earnings from investments; and
4. Fair value measurement

1. Business Purpose

The purpose of the entity should be to invest investors' funds solely for capital appreciation, investment income (e.g. dividends, interest or rental income), or both.

The business purpose might be evidenced through:

- Documents that indicate what the entity's investment objectives are, such as the entity's offering memorandum, publications distributed by the entity and other corporate or partnership documents; and
- The manner in which the entity presents itself to other parties (such as potential investors or potential investees).

For example, under IFRS 10.B85B, an entity may present its business as providing medium-term investment for capital appreciation which would be consistent with the business purpose of an investment entity. In contrast, an entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees has a business purpose that is <u>inconsistent</u> with the business purpose of an investment entity, because the entity will earn returns from the development, production or marketing activity as well as from its investments

Per IFRS 10.B85C, an entity will not be disqualified from being classified as an investment entity if it provides investment-related services (e.g. investment advisory services, investment management, investment support and administrative services), either directly or through a subsidiary, to third parties as well as its investors. Even if these activities are substantial, the entity is not disqualified, as these investment-related services are an extension of the entity's operations.

As noted under IFRS 10.B85D, an investment entity may also participate in the following investment-related activities, either directly or through a subsidiary, if these activities are undertaken to maximize the investment returns from the entity's investee's and do not represent a separate substantial business activity or a separate substantial source of income. These services are:

a) Providing management services and strategic advice to an investee; and
b) Providing financial support (such as a loan, capital commitment or guarantee) to an investee.

If an investment entity has a subsidiary that provides these services, the entity must consolidate that subsidiary in accordance with IFRS 10.32.

2. Exit strategies

The entity's exist strategy is another way determine its business purpose. Having an exit strategy for the entity's investments, including documented plans on how it will realize capital appreciation on its equity and non-financial investments; and a documented timeframe for exiting its investments. Exit strategies are not required for each individual investment, rather, exit strategies could be identified by types of portfolios held. Exit mechanisms only put in place for default events, such as a breach of contract, are not considered exit strategies for the purpose of this assessment.

Examples of exit strategies (IFRS 10.B85G):

- For investments in private equity securities:
  - an initial public offering,
  - a private placement,
  - a trade sale of a business,
  - distributions (to investors) of ownership interests in investees and
  - sales of assets (including the sale of an investee's assets followed by a liquidation of the investee).
- For equity investments that are traded in a public market:
  - selling the investment in a private placement or in a public market.
- For real estate investments:
  - the sale of the real estate through specialised property dealers or the open market.

Per IFRS 10.B85G, an investment entity may have an investment in another investment entity that is formed in connection with the entity for legal, regulatory, tax or similar business reasons. In this case, the investment entity investor need not have an exit strategy for that investment, provided that the investment entity investee has appropriate exit strategies for its investments.

3. Earnings from investments

If the entity or another member of the group can obtain, or has the objective of obtaining, other benefits from the entity's investees that are not available to unrelated parties, that investee is not held with the sole objective of obtaining capital appreciation, investment income, or both. Therefore, if the entity is holding the investment in this way, the entity would not qualify as an investment entity.

Benefits that would fall into this category would include (per IFRS 10.B85I):

a) The acquisition, use, exchange or exploitation of the processes, assets or technology of an investee. This would include the entity or another group member having disproportionate, or exclusive, rights to acquire assets, technology, products or services of any investee; for example, by holding an option to purchase an asset from an investee if the asset's development is deemed successful;
b) Joint arrangements (as defined in IFRS 11) or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services;
c) Financial guarantees or assets provided by an investee to serve as collateral for borrowing arrangements of the entity or another group member (however, an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings);
d) An option held by a related party of the entity to purchase, from that entity or another group member, an ownership interest in an investee of the entity;

e) Transactions between the entity or another group member and an investee that:
   i. Are on terms that are unavailable to entities that are not related parties of either the entity, another group member or the investee;
   ii. Are not at fair value; or
   iii. Represent a substantial portion of the investee's or the entity's business activity, including business activities of other group entities.

An investment entity may have the business purpose to have a strategy to invest in more than one investee in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income of those investments. However, if the entity is receiving any returns beyond capital appreciation, investment income, or both, then it would not be considered an investment entity.

4. Fair value measurement

The consolidation exemption in IFRS 10 requires an investment entity to measure its investments at fair value. The requirement to measure at fair value applies to investments, it does not apply to non-investment assets or to financial liabilities (IFRS 10.B85M).

Using fair value results in more relevant information than, for example, consolidating its subsidiaries or using the equity method for its interests in associates or joint ventures. In order to demonstrate that it meets this element of the definition, an investment entity:

a) Provides investors with fair value information and measures substantially all of its investments at fair value in its financial statements whenever fair value is required or permitted in accordance with IFRSs; and
b) Reports fair value information internally to the entity's key management personnel (as defined in IAS 24), who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

Per IFRS 10.B85L, to meet the requirement in (a) above, an investment entity would:

a) elect to account for any investment property using the fair value model in IAS 40, *Investment Property*;
b) Elect the exemption from applying the equity method in IAS 28 for its investments in associates and joint ventures; and
c) Measure its financial assets at fair value using the requirements in IFRS 9.

Typical characteristics of an investment entity

In determining whether an entity meets the definition of an investment entity, an entity shall consider whether is displays the typical characteristics of one, they are:

1. Holding more than one investment
2. Having more than one investor
3. Having unrelated investors
4. Ownership interests in the form of equity or similar interests

1. More than one investment

An investment entity typically holds several investments to diversify its risk and maximise its returns. An entity may hold a portfolio of investments directly or indirectly, for example by holding a single investment in another investment entity that itself holds several investments. (IFRS 10.B85O)

There may be times when the entity holds a single investment. However, holding a single investment does not necessarily prevent an entity from meeting the definition of an investment entity. For example, an investment entity may hold only a single investment when the entity:

a) Is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire several investments;
b) Has not yet made other investments to replace those it has disposed of;
c) Is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (e.g. when the required minimum investment is too high for an individual investor); or
d) Is in the process of liquidation.
(IFRS 10.B85P)

2. More than one investor

Typically, an investment entity would have several investors who pool their funds to gain access to investment management services and investment opportunities that they might not have had access to individually. Having several investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income (IFRS 10.B85Q)

Alternatively, an investment entity may be formed by, or for, a single investor that represents or supports the interests of a wider group of investors (e.g. a pension fund, government investment fund or family trust). (IFRS 10.B85R)

There may also be times when the entity temporarily has a single investor. For example, an investment entity may have only a single investor when the entity:

a) Is within its initial offering period, which has not expired and the entity is actively identifying suitable investors;

b) Has not yet identified suitable investors to replace ownership interests that have been redeemed; or

c) Is in the process of liquidation
(IFRS 10.B85S)

3. Unrelated Investors

Typically, an investment entity has several investors that are not related parties of the entity or other members of the group containing the entity. Having unrelated investors would make it less likely that the entity, or other members of the group containing the entity, would obtain benefits other than capital appreciation or investment income. (IFRS 10.B85T)

However, an entity may still qualify as an investment entity even though its investors are related to the entity. For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties. (IFRS 10.B85U)

4. Ownership interests

An investment entity is typically, but is not required to be, a separate legal entity. Ownership interests in an investment entity are typically in the form of equity or similar interests (e.g. partnership interests), to which proportionate shares of the net assets of the investment entity are attributed. However, having different classes of investors, some of which have rights only to a specific investment or groups of investments or which have different proportionate shares of the net assets, does not preclude an entity from being an investment entity. (IFRS 10.B85V)

In addition, an entity that has significant ownership interests in the form of debt that, in accordance with other applicable IFRSs, does not meet the definition of equity, may still qualify as an investment entity, provided that the debt holders are exposed to variable returns from changes in the fair value of the entity's net assets. (IFRS 10.B85W)

Accounting by an investment entity

IFRS 10 requires an entity that is a parent to present consolidated financial statements. The exemption for investment entities under the standard exempts investment entities from consolidating underlying investees that it controls. It requires investment entities to account for these subsidiaries at fair value through profit or loss under IFRS 9 *Financial Instruments*.

Notwithstanding the exemption from consolidation, if an investment entity has a subsidiary that provides services that relate to the investment entity's investment activities, it shall consolidate that subsidiary. This would include investment management, advisory and administrative support services either directly or through a subsidiary, to third parties as well as its investors. (This will not disqualify an entity from being classified as an investment entity, per IFRS 10.B85C, Even if these activities are substantial, as these investment-related services are an extension of the entity's operations).

Accounting by the parent of an investment entity

A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity. That is, if the parent does not quality as an investment entity, it must consolidate all entities that it controls.

Disclosures

IFRS 12 *Disclosure of interests in other entities,* includes disclosure requirements for investment entities with controlled subsidiaries.

The investment entity shall disclose:

- Information about significant judgements and assumptions it has made in determining that it is an investment entity. (IFRS 12.9A)
- If the investment entity does not have one or more of the typical characteristics of an investment entity, it shall disclose its reasons for concluding that it is nevertheless an investment entity. (IFRS 12.9A)
- When the entity becomes, or ceases to be, an investment entity, it shall disclose the change of investment entity status and the 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:
    a) The total fair value, as of the date of change of status, of the subsidiaries that cease to be consolidated;
    b) The total gain or loss, if any, calculated in accordance with paragraph B101 of IFRS 10; and
    c) The line item(s) in profit or loss in which the gain or loss is recognised (if not presented separately). (IFRS 12.9B)
- When an investment entity is required to apply the exemption to consolidation and account for its investments at fair value through profit or loss it shall disclose that fact. (IFRS 12.9A)
- Information on each unconsolidated subsidiary:
    - The subsidiaries name;
    - The principal place of business (and country of incorporation if different than the principal place of business) of the subsidiary; and
    - The proportion of ownership interest held by the investment entity and, if different, the proportion of voting rights held.
      (IFRS 12.19B)
- If an investment entity is the parent of another investment entity, the parent shall also provide the disclosures in IFRS 19B (a-c) as noted above, for investments that are controlled by its investment entity subsidiary. The disclosure may be provided by including, in the financial statements of the parent, the financial statements of the subsidiary (or subsidiaries) that contain the above information. (IFRS 12.19C)
- An investment entity shall disclose:
    a) The nature and extent of any significant restrictions (e.g. resulting from borrowing arrangements, regulatory requirements or contractual arrangements) on the ability of an unconsolidated subsidiary to transfer funds to the investment entity in the form of cash dividends or to repay loans or advances made to the unconsolidated subsidiary by the investment entity; and
    b) Any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support. (IFRS 12.19D)

- If, during the reporting period, an investment entity or any of its subsidiaries has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated subsidiary (e.g. purchasing assets of, or instruments issued by, the subsidiary or assisting the subsidiary in obtaining financial support), the entity shall disclose:
  a) The type and amount of support provided to each unconsolidated subsidiary; and
  b) The reasons for providing the support.
  (IFRS 12.19E)

- An investment entity shall disclose the terms of any contractual arrangements that could require the entity or its unconsolidated subsidiaries to provide financial support to an unconsolidated, controlled, structured entity, including events or circumstances that could expose the reporting entity to a loss (e.g. liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or to provide financial support). (IFRS 12.19F)
- If during the reporting period an investment entity or any of its unconsolidated subsidiaries has, without having a contractual obligation to do so, provided financial or other support to an unconsolidated, structured entity that the investment entity did not control, and if that provision of support resulted in the investment entity controlling the structured entity, the investment entity shall disclose an explanation of the relevant factors in reaching the decision to provide that support. (IFRS 12.19G)

Effective date

The exemption criteria is effective for periods beginning on or after January 1, 2014. Early application is permitted. If applied early, it shall disclose that fact and apply all amendments to other standards affected (IFRS 10, IFRS 12 and IAS 27).

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