Consolidation Exception for Investment Entities

A Review of the Investment Entities – Amendments to IFRS 10, IFRS 12 and IAS 27

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1. Background

IFRS 10 *Consolidated Financial Statements* introduces a new control model to identify a parent-subsidiary relationship. The control model is a qualitative model, premised on the existence of the three elements of "power", "returns", and the "link between power and returns". With this change, many previously unconsolidated investees may meet the definition of a subsidiary and henceforth must be consolidated. Venture capital organisations, mutual funds, trust funds, asset management entities and similar investment-type entities that have previously treated their investees as associates or joint ventures, would need to reassess their involvement with those investees, and if the control model is met, must henceforth consolidate those investees. The option of using the fair value model for such investees would no longer be available if they control their investees.

In accounting literature, it has long been advanced that if an investor controls an investee, presenting consolidated financial statements would provide a fairer presentation of the results and financial position of entities operating as a group. This has been the stance taken in accounting standards, such as the original IAS 27, over the years. IFRS 10 further enhances the consolidation principle by requiring that an investor must consolidate all assets and liabilities under its control regardless of how they have been structured, whether in legal investees, in structured entities or in ring-fenced silos. No consolidation exception was made when the original IFRS 10 was issued in May 2011.

However, in October 2012, the IASB issued *Investment Entities – Amendments to IFRS 10, IFRS 12 and IAS 27* ("the Amendments") to provide an exception to the consolidation requirements of IFRS 10 for investment entities. The amended IFRS 10 now requires an investment entity to measure its subsidiaries at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments* in its financial statements, rather than by consolidation.

2. Why the Change?

Preparers and investors in the investment entity industry have, for many years, argued that measuring the subsidiaries of investment entities at fair value provides more relevant information than consolidating those subsidiaries. Certain exemptions have already been given in the IFRSs for investments in associates and joint ventures, where venture capital organisations, mutual funds and similar investment-type entities may elect to measure those investments at fair value through profit or loss rather than by equity accounting.

The IASB received similar request for consolidation exception during the development of IFRS 10. Investors in the investment-type industry have said that consolidating the subsidiaries of investment entities makes it difficult to assess the value of their investments. Preparers of financial statements have argued that preparing consolidated financial statements for investment entities is time-consuming and costly and provides little benefit, because investors are more interested in the non-consolidated, fair value information. However, the exemption for associate and joint venture equity accounting was previously not extended to the consolidation requirements in the accounting standards, such as the former IAS $27_{(2008)}$ *Consolidated and Separate Financial Statements* and the original IFRS $10_{(2011)}$.

Some respondents to the Exposure Draft on this IFRS did not agree with the exception and believed that consolidation is equally, if not more, relevant for decision-making purposes of investment entities. They also thought that creating an exception to consolidation undermines the principle of control, creates the potential for accounting abuse and reduces the usefulness of the financial statements. Others opined that decision-useful fair value information can be met by making fair value measurement a mandatory requirement in the separate financial statements (the then current IAS $27_{(2011)}$ *Separate Financial Statements* provided an option of the cost method or the fair value method), and retaining the consolidation requirement. However, this alternative would involve extra costs if the consolidation requirement is retained but with little benefit.

For investment entities, all their investments are usually measured and evaluated on a fair value basis, including investments in subsidiaries. The current IFRSs either require or permit fair value measurement for most investments, but before the Amendments, investments in subsidiaries were required to be consolidated and could not be measured at fair value. This created an anomaly in that an investment entity with no subsidiaries would be able to measure all of its investments at fair value, whereas an investment entity with one subsidiary would have to consolidate that investee. The IASB believes that introducing an exception to consolidation for investment entities improves comparability both within an investment entity's financial statements and between investment entities' financial statements.

When developing IFRS 10, the IASB and the US FASB were already working on a joint project to eliminate differences between US GAAP and IFRSs with respect to consolidation. One of the convergence areas was on investment entities. The US GAAP already had accounting and reporting guidance for investment companies. Before the convergence to IFRSs, national standards of some jurisdictions had permitted the consolidation exception for investment-type entities. In February 2010, the IASB together with the FASB began examining the possibility of creating a consolidation exception and aligning the IFRS and the US GAAP. The US FASB is proposing the consolidation exception for investment entities in the US GAAP. Although this consolidation exception appears to be industry-driven, the feedback from the respondents to IFRS $10_{(2011)}$ and the joint project with the US FASB are persuasive to warrant a change in stance taken previously.

Providing consolidation exception is tantamount to an override of accounting principles, and in this instance, a conflict with the principle of control. In the Basis of Conclusion to the Amendments, the rationale for the change in stance is not explicitly stated but could be inferred from the discussions therein. The justification is more likely to be a combination of the following reasons:

(a) *Relevant information* - the decision-useful fair value information criterion for investors in the investment entity industry is given precedence over the underlying principle of consolidation;
(b) *Costs-benefits consideration* - the costs of preparing consolidated financial statements outweigh the marginal benefits of consolidation because investors in this industry are more interested in the fair value information;
(c) *Comparability* – measuring all investments at fair value, including investments in subsidiaries, enhances comparability of financial statements both within an investment entity and across investment entities; and

(d) C*onvergence* with the US GAAP on the same topic.

If fair value measurement for investments in subsidiaries is more relevant for decision-making needs of investors in the investment entity industry, the same argument may also be advanced for investors in other industries. For example, investors of public listed entities may also be more interested in the fair value information, and can the same consolidation exception be extended to public listed entities? The IASB has been reluctant to create an exception to the principle that when one entity controls another, the parent consolidates its subsidiary. However, it was persuaded by the consistent message from investors that, for this narrowly defined type of entity, measuring all of its investments at fair value provides investors with the best information. The consolidation exception of the amended IFRS 10 is thus narrowly-focussed and does not apply to non-investment entities. The IASB has ensured that this exception is available only to entities that evaluate the performance of their investments on a fair value basis. Whether fair value measurement or consolidation is more relevant for decision-making in other industries can be an area of academic interest, but it would be premature at the current stage of accounting to suggest a fair value measurement of subsidiaries for all industries.

3. The Salient Features

The amended IFRS 10 adopts an entity-based approach whereby the exception to consolidation is based on the type of entity that owns subsidiaries. When compared with the Exposure Draft, the approach to identifying an investment entity is changed slightly in the amended IFRS 10. The requirements now include a *definition* with associated "*typical characteristics*" that capture the business model and core activities of an investment entity. These mean that a reporting parent would need to assess whether it is an investment entity by performing a primary test of the definition (mandatory elements) and a secondary test of the typical characteristics (non-mandatory criteria).

3.1 The Definition

The amended IFRS 10 defines an investment entity as 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 (IFRS 10.27).

The definition of an investment entity consists of all three elements, and thus a reporting parent must consider all facts and circumstances, including its purpose, design and internal reporting. These are explained below.

Business Purpose

The purpose of the entity must be to invest solely for capital appreciation, investment income (such as dividends, interest or rental income), or both. This may be evidenced in documents such as the entity's offering memorandum, publications distributed by the entity and other corporate or partnership documents. Further evidence may include the manner in which the entity presents itself to other potential investors or potential investees, such as by stating that its business purpose is providing medium-term investments for capital appreciation.

The essence of the new control model in IFRS 10 is that a parent must have the current ability to direct the relevant activities of its subsidiary so as to extract variable returns for its involvement with the investee. A parent is not precluded from being classified as an investment entity simply because it actively exercises its power in directing the relevant activities to extract returns. What distinguishes an investment entity from non-investment entities is that the management of its investee (such as giving financial support or directing strategic policies) is for the sole purpose of maximising the overall value of the investee (i.e. to maximise capital appreciation), rather than to obtain other benefits (such as earnings, cash flows, cost savings and other synergies). Thus, if active directing of investees includes management of separate substantive business activities or for income other than capital appreciation, the parent is not an investment entity.

Provision of Investment-Related Services

An investment entity may provide investment-related services, such as investment advisory services, investment management, investment support and administrative services to third parties as well as to its investors. It does not matter if the investment-related services of an investment entity are undertaken indirectly through a subsidiary as the provision of investment-related services to its investors is an extension of the investment entity's investing activities. The provision of investment-related services does not disqualify the entity to be an investment entity under the Standard, even if those activities are substantial to the entity.

Exit Strategy

An investment entity differs from other entities in that it does not hold its investments indefinitely. To qualify as an investment entity, the reporting entity must have an exit strategy documenting how it plans to realise capital appreciation from substantially all of its equity investments, non-financial asset investments (such as investment property) and perpetual debt instruments. This need not necessarily be in terms of specific exit strategies for each individual investment but the entity must identify different potential strategies for different types or portfolios of investments, including a substantive time frame for exiting the investments. For example, if an investment entity has investments in private equity securities, its exit strategy for this type of investments may include exiting after an initial public offering or a private placement.

The absence of an exit strategy for investments in subsidiaries would suggest that the investments are made not only for investment returns (capital appreciation, investment income or both) but also other benefits (such as earnings, cash flows and synergies). For example, if a venture capital entity actively directs the relevant activities of its subsidiaries to extract variable returns, it is not precluded from being classified as an investment entity so long as it has documented how its plans to realise capital appreciation from those investments. In the absence of an exit strategy, it would be difficult to justify that the investments are made *solely* for investment returns.

Fair Value Measurement

The element of fair value measurement requires that an investment entity measures and evaluates the performance of substantially all of its investments on a fair value basis. The investment entity thus: (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 by

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.

If an entity's internal reporting to key management personnel includes fair value information and other information (such as earnings and net asset values of investees), the entity is an investment entity only if its key management personnel use the fair value information as the primary measurement attribute to evaluate performance and to make resource-allocation investment decisions. If both fair value information and other information are used in performance evaluation and investment decisions, it would appear that the fair value measurement element is not met because fair value is not the primary measurement attribute in internal reporting. Some respondents had expressed concerns that this requirement is too restrictive and may disqualify some venture capital organisations from the consolidation exception. As mentioned earlier, the IASB intended that the exception is only available for entities that evaluate the performance of their investments on the fair value basis.

The fair value measurement element applies equally to investments in unquoted subsidiaries. Some investment-type entities use net asset value (NAV) as the primary measurement attribute to evaluate performance of their unquoted subsidiaries and for resource-allocation investment decisions. They have proposed to the IASB that the IFRS should allow, as a practical expedient, the use of NAV as a surrogate for, or equivalent of, the fair value measurement requirement. The amended IFRS 10 does not provide for a practical expedient exception because guidance on how to measure fair value, including unquoted equity investments, is already provided in IFRS 13 *Fair Value Measurement*.

In order to meet the fair value measurement requirement of an investment entity, all other investments, whether financial or non-financial, must also be measured at fair value. Thus, an investment entity *must*:

(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 Investments in Associates and Joint Ventures* for its investments in associates and joint ventures; and
(c) measure its financial assets, including debt instruments, at fair value using the requirements in IFRS 9 *Financial Instruments*.

The fair value measurement element of the definition applies only to an investment entity's investments. Accordingly, an investment entity need not measure its non-investment assets (such as head office property and related equipment) and its financial liabilities at fair value.

3.2 Typical Characteristics

In assessing whether it meets the definition of an investment entity, an entity considers whether it has the following four *typical characteristics* of 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
(d) It has ownership interests in the form of equity or similar interests.

As the above are only typical characteristics, the absence of any does not necessarily disqualify an entity from being classified as an investment entity, but indicates that additional judgement is required. An investment entity that does not have any of these typical characteristics must provide additional disclosure in accordance with the amended IFRS 12 on the judgements made and the reasons for concluding that it is an investment entity. However, if all the four typical characteristics are absent, it is unlikely that an entity can meet the definition of an investment entity.

An investment entity typically holds several investments to diversify its risk and maximise its returns. It may hold a single investment in another investment entity that itself holds several investments. There may be times when an investment entity holds only a single investment, for example, when it is in its start-up period or has not yet made other investments to replace those it has disposed of.

An investment entity would typically have several investors who pool their funds to gain access to investment management services and investment opportunities. 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). There may also be times when the entity temporarily has a single investor, such as when the entity is within the initial offering period, which has not expired and the entity is actively identifying suitable investors or has not yet identified suitable investors to replace ownership interests that have been redeemed.

An investment entity would typically have several investors that are not related parties of the entity or other members of the group containing the entity. 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 or other related parties, 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.

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, to which proportionate shares of the net assets of the investment entity are attributed. However, having different classes of investors with differing rights to share of net assets does not preclude an entity from being an investment entity.

3.3 Common Types of Investment Entities

The common types of investment entities envisaged in the amended IFRS are private equity organisations, unit trust funds, venture capital organisations, employee benefit plans and other pension funds, sovereign wealth funds and other investment funds. However, it does not automatically mean that all entities in this group qualify as an investment entity as they would need to meet the primary test of the mandatory elements and the secondary test of the typical characteristics. On the other hand, other entities not included in this group, such as a holding company or a government-linked fund, may also meet the elements of an investment entity.

3.4 Changes to Elements or Typical Characteristics

If facts and circumstances indicate that there are changes to one or more of the three elements that make up the definition, or the four typical characteristics, of an investment entity, a parent reassesses whether it is an investment entity. An investment entity ceases to be one if any of the three elements is no longer met, for example, when following a change in its business model, it no longer reports and evaluates performance on the fair value basis. On the other hand, a parent might previously not qualify as an investment entity because its business model did not internally measure and evaluate investments in subsidiaries on the fair value basis. If its business model is changed to one of measuring and evaluating performance on the fair value basis, it becomes an investment entity in this IFRS.

A parent that either ceases to be an investment entity or becomes an investment entity accounts for the change in its status *prospectively* from the date at which the change in status occurred.

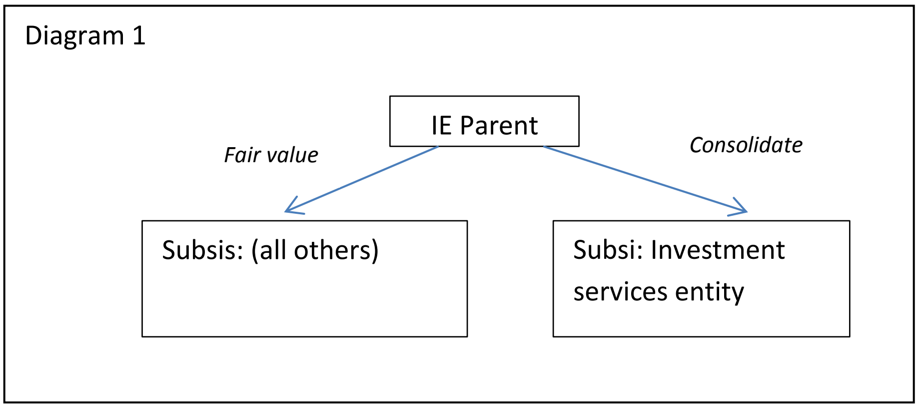
4. The Accounting Treatments and Presentation Requirements

The Amendments represent an exception (not an exemption or an accounting policy choice) in that an investment entity shall not consolidate particular subsidiaries or apply IFRS 3 when it obtains control of another entity. Instead, an investment entity shall measure its investments in particular subsidiaries at fair value through profit or loss in accordance with IFRS 9 [see IFRS 10.31].

An Exception to the Exception

It does not matter if the investment-related services of an investment entity are undertaken directly by itself or indirectly through a subsidiary, as the essence of an investment entity is the provision of investment management services to its investors. Thus, if an investment entity has a subsidiary that provides services that relate to the investment entity's investment activities, it consolidates that subsidiary and apply the requirements of IFRS 3 to the acquisition of any such subsidiary [IFRS 10.32]. The consolidation exception in the amended IFRS 10 applies only to particular subsidiaries that are measured at fair value through profit or loss, but not to a subsidiary that provides investment-related services of its investment entity parent's investment activities.

In this case, the investment entity presents a set of consolidated financial statements that combines itself with the subsidiary that provides its investment-related services, whilst other subsidiaries are measured at fair value through profit or loss [See Diagram 1 below].



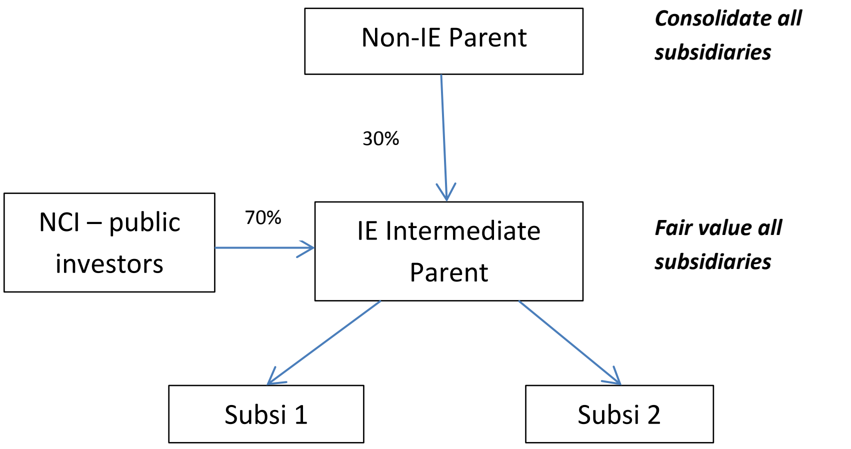
The amended IFRS 10 does not provide for other circumstances in which a subsidiary of an investment entity must be consolidated. This means that the "particular subsidiaries" requirement for the consolidation exception is determined by default i.e. all others that are not entities that provide investment-related services of their investment entity parent.

Parent of an Investment Entity

If decision-useful information is a persuasive criterion for measuring subsidiaries at fair value of an investment entity parent, some constituents have also advanced that the same argument should be applied to investors of the parent of an investment entity. If this is the case, the fair value measurement applied by an intermediate investment entity parent would also be extended to the financial statements of the parent of an investment entity. However, the argument that fair value provides more relevant information for an investment entity is not extended to the investors of its non-investment entity parent. The exception to consolidation is only for investment entities because of their unique business model. The IASB had concerns with allowing a non-investment entity parent to retain the fair value accounting used by its investment entity subsidiaries as this would enable a reporting parent to conceal leverage in a non-consolidated subsidiary. The IASB concluded that because non-investment entity parents do not have the unique business model, they shall consolidate all their subsidiaries.

Thus, a parent of an investment entity consolidates all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity [IFRS 10.33].

Diagram 2



A Change in Investment Entity Status

When an entity ceases to be an investment entity, it applies IFRS 3 to any subsidiary that was previously measured at fair value through profit or loss. For this purpose, the date of the change of status is the deemed acquisition date. The fair value of the investment in the subsidiary at the deemed acquisition date represents the deemed consideration transferred when measuring goodwill or gain from a bargain purchase that arises from the deemed acquisition. Thus, all subsidiaries shall be consolidated from the date of change of status.

If the entity is required by law or regulation, or by election, to present separate financial statements, the option of measuring investments in subsidiaries at fair value or at cost in IAS 27 remains available. Thus, the entity may continue to measure an investment in a subsidiary at fair value through profit or loss in its separate financial statements. If the cost method is availed, the fair value of the investment at the date it ceases to be an investment entity is treated as the deemed cost for the subsequent accounting [see added paragraph IAS 27.11B(a)].

However, the entity must prepare and present consolidated financial statements when the status is changed. It applies IFRS 3 for the purchase price allocation and goodwill calculation at that date of change of status, as illustrated below (using hypothetical figures).

Example (Ceases to be an Investment Entity)

	RM'000
Deemed consideration transferred – fair value of investment	6,000
NCI – at acquisition-date fair value or at net asset value*	4,000

Aggregate	10,000
Fair value of identifiable net assets at deemed acquisition date	8,000

Goodwill on combination	2,000
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Note: IFRS 3 allows an investor to measure NCI at acquisition-date fair value or at its share of net asset value*

When an entity becomes an investment entity, it ceases to consolidate its subsidiaries at the date of change in status (except for a subsidiary that provides investment-related services of its investment entity parent). The investment entity applies the requirements of loss of control and derecognition to those subsidiaries that it ceases to consolidate as though the investment entity had lost control of those subsidiaries at that date i.e. treated as a deemed disposal [see added paragraph IFRS 10.B101].

The requirement to cease consolidation of subsidiaries only at the date of change of status means that the entity must continue to consolidate the results of the subsidiaries for the period before the entity becomes an investment entity. At the date of change of status, it applies the requirement of loss of control of IFRS 10 to each subsidiary in its consolidated financial statements, as follows (using hypothetical figures):

Example – (Becomes an Investment Entity)

	RM'000
Deemed consideration received – fair value of investment	15,000
Assets (including goodwill) derecognised	(16,000)
Liabilities derecognised	2,000
NCI derecognised	3,000

Gain before reclassification adjustments	4,000
Reclassification adjustments of OCI reserves	2,000

Gain on derecognition in profit or loss	6,000
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The effects of the deemed disposal in the profit or loss for the period are disclosed in the notes to the consolidated financial statements presented.

Similarly, in the separate financial statements, when an entity becomes an investment entity, it shall measure an investment in a subsidiary at fair value through profit or loss. The difference between the carrying amount of the investment in that subsidiary and its fair value at the date of change of status is recognised as a gain or loss in profit or loss. Any cumulative other comprehensive income in respect of that subsidiary is also recycled to profit or loss, as if the entity had disposed of the subsidiary at the date of change of status [see IAS 27.11B(b)].

Using the above Example, if the investment in the subsidiary was previously carried at cost of RM8 million and there were no OCI reserves, the gain recognised in the separate profit or loss is RM7 million i.e. fair value of RM15 million less cost carrying amount of RM8 million.

In the consolidated financial statements, after applying the loss of control requirement, the investment in a subsidiary is measured at fair value through profit or loss in the subsequent accounting. The assets, liabilities and equity of that subsidiary would no longer be relevant for consolidation of the statement of financial position at the end of the reporting period.

If an entity that becomes an investment entity has no subsidiary that undertakes its investment-related services, the consolidated statement of comprehensive income would include the results of all its subsidiaries for the period before the date of change of status. Thereafter, the accounting for subsidiaries in the consolidated financial statements would be the same as in the separate financial statements. And the consolidated statement of financial position at the end of the reporting period converges or is identical to the separate statement of financial position. Comparing the consolidated financial statements of the current period with the consolidated financial statements of prior periods may not be meaningful. Although consolidation is applied in that current period and in the corresponding prior periods, the added paragraph IFRS 10.4(c) provides for a presentation option in that an investment entity need not present its consolidated financial statements if it measures all of its subsidiaries at fair value through profit or loss. In the immediately succeeding period, consolidation would be irrelevant and the investment entity presents separate financial statements as its only financial statements if it avails the option in paragraph IFRS 10.4(c).

5. Consequential Amendments to IFRS 12 and IAS 27

IFRS 12 has been amended to require an investment entity to disclose the significant judgements and assumptions made in determining that it meets the definition of an investment entity. This would be applicable if the investment entity does not have one or more of the typical characteristics of an investment entity, in which case, it shall disclose its reasons for concluding that it is nevertheless an investment entity.

When an entity becomes, or ceases to be, an investment entity, it discloses the change of investment entity status and the reasons for the change. In addition, an entity that becomes an investment entity discloses the effects of change of status on the financial statements for the period presented, including the total fair value of the subsidiaries that cease to be consolidated, the total gain or loss on deconsolidation and the line item in profit or loss in which the gain or loss is recognised.

A new section has been added in the IFRS to require disclosures about interests in unconsolidated subsidiaries of investment entities. These include the fact that an investment entity has applied the consolidation exception, some limited information about each unconsolidated subsidiary, and the proportion of ownership interest and voting rights. Other disclosures in this new section are on understanding risks and commitments. These are similar to those prescribed for unconsolidated structured entities, and they include significant restrictions, commitments and intentions to provide financial or other support.

It should be noted that when the fair value measurement is applied for investments in subsidiaries, the extent of non-controlling interests (NCIs) is irrelevant in the measurement. Thus, the requirement to disclose detailed summarised financial information about NCIs' interests for consolidated subsidiaries, such as NCIs' share of comprehensive income and net assets, and other summarised data, are not applicable for unconsolidated subsidiaries.

The new paragraph IAS 27.8A prescribes that an investment entity that is required, throughout the current period and all comparative periods presented, to apply the consolidation exception of IFRS 10 for all of its subsidiaries presents separate financial statements as its only financial statements. This would not be applicable if an investment entity has consolidated a subsidiary that provides the investment entity's investment-related services, in which case, consolidated financial statements must also be presented. Similarly, if an entity becomes an investment entity at a particular date in the current period and it has consolidated all of its subsidiaries before that date, the condition of "throughout the current period and all comparative periods presented" is not met. However, the investment entity may avail the option of not presenting its consolidated financial statements (including comparative consolidated financial statements of prior periods) in paragraph IFRS 10.4(c).

The option of the cost model for an investment entity's accounting for investments in subsidiaries, associates and joint ventures has been removed as all such investments must be measured at fair value through profit or loss in the separate financial statements (in the same way as in the consolidated financial statements) [see IAS 27.11A].

6. Effective Date and Transition Provisions

The amended IFRSs are effective for annual periods beginning on or after 1 January 2014, with earlier application permitted. Note that the effective date of both IFRS 10 and IFRS 12 is 1 January 2013. A parent, including an investment entity parent, would need to consolidate all its subsidiaries and apply IFRS 3 for the acquisitions of those subsidiaries for the annual period ending 31 December 2013. A parent that is an investment entity would then have to deconsolidate its subsidiaries and apply the fair value measurement for the annual period beginning on or after 1 January 2014. To avoid having to consolidate in one year and to then deconsolidate in the next year, an investment entity may avail the early application to measure its investments in subsidiaries at fair value when both IFRS 10 and IFRS 12 are applied for the first time in 2013.

An entity is required to assess whether it is an investment entity on the basis of facts and circumstances that exist at the date of initial application of the Amendments. At the date of initial application, an investment entity measures its investment in each subsidiary at fair value through profit or loss as if the requirements of the IFRS had always been effective. It retrospectively adjusts both the annual period that immediately precedes the date of initial application and equity at the beginning of the immediately preceding period for any difference between: (a) the previous carrying amount of the subsidiary; and (b) the fair value of the investment entity's investment in the subsidiary. The cumulative amount of any fair value adjustments previously recognised in other comprehensive income (OCI), such as exchange translation reserve or revaluation reserve, is transferred to retained profits at the beginning of the annual period immediately preceding the date of initial application. The requirement of retrospective adjustment applies equally to both the consolidated financial statements and the separate financial statements of an investment entity

> For example, an investment entity has an annual financial period ending on 31 December 2014. Its date of initial application of the Amendments is 1 January 2014. It had previously consolidated its wholly-owned subsidiary up to 31 December 2013. At the opening of business on 1 January 2013, the net assets of the subsidiary, including goodwill, were RM10 million and the related accumulated OCI reserves were RM2 million. In the separate financial statements, the investment was recorded at cost amount of RM5 million. The fair value of the investment in the subsidiary on 1 January 2013 was RM15 million.
>
> In the consolidated financial statements, the adjustment to the opening retained profits on 1 January 2013 is a credit of RM7 million. In the separate financial statements, the adjustment to the opening retained profits on 1 January 2013 is RM10 million.

The retrospective adjustment to equity at the beginning of the immediately preceding period effectively makes a reporting entity an investment entity at that date. If the reporting entity has no subsidiary that undertakes its investment-related services, the subsequent accounting for investments in subsidiaries after the retrospective adjustment for the comparative annual period that precedes the date of initial application and the current annual period would be the same for both the consolidated financial statements and the separate financial statements. The reporting entity applies the requirement of IAS 27.8A to present separate financial statements as its only financial statements.

The Amendments provide for an impracticability exemption in that the fair value measurement is applied at the beginning of the earliest period for which application is practicable, which may be the current period. If this is the case, the adjustment to equity shall be recognised at the beginning of the current period.

If an investment entity has disposed of, or has lost control of, a subsidiary before the date of initial application of this IFRS, the investment entity is not required to make adjustments to the previous accounting for that subsidiary.

7. Implications and Potential Implementation Issues

A clear advantage of applying the fair value measurement for investments in subsidiaries is the simplified accounting requirements, which are confined only to measurement of fair value and recognising the changes in fair value in profit or loss. The complex requirements of business combination accounting (such as purchase price allocation and goodwill), goodwill allocation and impairment testing, step-acquisition, changes in stakes, and accounting for loss of control and the consequential recycling of OCI reserves would be irrelevant in a fair value measurement model. In this regard, cost savings are expected in the accounting procedures on the immediate application of the amended IFRSs and thereafter.

Another apparent advantage of the fair value measurement for investments in subsidiaries is the alignment of the accounting and reporting with an investment entity's business model. This would enable investors to see through the "eyes of management" its resource-allocation investment decisions. It also enhances comparability of financial statements within an entity and across entities.

The business purpose element of investing solely for capital appreciation, investment income or both is not unique to investment entities because all investments of all entities are made for that ultimate purpose of maximising wealth of their investors. Returns in whatever forms (earnings, cash flows, cost-savings and other synergies) are all linked to maximising value of investments. It would be difficult to draw the line between managing solely for investment returns and managing for other benefits because resource allocation investment decisions are largely behaviour-driven, not something that can be easily tested. Thus, formal documentation of business purpose appears to be the only sufficient evidence for this element.

The most critical element to justify a consolidation exception for investment entities is the fair value measurement in internal reporting and evaluation of performance. The manner in which an entity evaluates performance and makes resource-allocation investment decisions is thus the key determinant in concluding whether it is an investment entity. This is likely to be an area that requires significant judgements. For example, if internal reporting of investments in subsidiaries to key management personnel is based on both fair value measurement and other measurements (earnings and net asset values), determining which basis is the primary measurement attribute to evaluate the performance of the subsidiaries or for resource-allocation investment decisions is subjective.

Venture capital organisations, mutual funds, trust funds and asset management entities would need to reassess whether they qualify as an investment entity i.e. whether they meet the three specified elements and the four typical characteristics. If any such entity is an investment entity, the option of the equity method for its investments in associates or joint ventures is no longer available, which means that it must henceforth account for those investments using the fair value basis. And if any of those investments has become a subsidiary under the new control model of IFRS 10, that subsidiary must also be measured at fair value.

Some venture capital organisations and asset management entities use net asset values (NAV) of their unquoted investees as a basis for reporting internally to key management personnel. As mentioned earlier, the Amendments do not provide for a practical expedient for the use of NAV as a surrogate of fair value. Henceforth, such entities may need to revise their internal reporting to management by using fair value, rather than NAV, for subsidiaries and other investments, to qualify as an investment entity. For entities in this industry that do not qualify as an investment entity, they would need to consolidate all subsidiaries, but the option of fair value measurement for investments in associates and joint ventures remains available.

Although the Amendments were issued in response to the needs of preparers and users in the investment-type industry, the application is not limited or confined to that industry. In other words, so long at the definition of an investment entity is met, a parent must apply the requirements in the Amendments to account for its subsidiaries. Thus, any parent, whose principal activity is that of holding investments (commonly known as holding company), including investments in subsidiaries, associates and joint ventures, would also need to test whether it qualifies as an investment entity. This includes government investment funds and government-linked investment funds. If it reports internally to key management personnel on a fair value basis and internal decisions about resource allocations are made on that basis, it is an investment entity (assuming the other elements and typical characteristics are met). Henceforth, such parent shall use only the fair value measurement for external reporting. A “tricky” part of the IFRS is that it does not prevent an entity from deliberately disqualifying itself as an investment entity (assuming it prefers consolidation rather than fair value measurement) by simply stopping fair value measurement reporting to key management.

For an investment holding company that does not use fair value measurement for internal reporting and resource-allocation decisions, or does not have an exit strategy for its investments in subsidiaries, it would not qualify as an investment entity. The IFRS does not compel such entities to change its internal reporting or processes of resource-allocation decisions. This means that such parent would continue to consolidate its subsidiaries. However, if such a parent wants to avail the consolidation exception, it must change its internal reporting and processes of resource-allocation decisions and document an exit strategy to become an investment entity. The notion implied in the IFRS is that fair value measurement provides more relevant information to investors, and presumably, also leads to better internal resource allocations by management (although some constituents do not hold this view and believe that consolidation is a better basis). If a change is to be made, there will be initial set-up costs on systems and processes although cost savings may be realisable in the longer term.

Another potential implement issue is that for an investment holding company which had previously consolidated all its subsidiaries and presented segmental report in accordance with IFRS 8 *Operating Segments*, it is unclear whether segment reporting would continue to apply when that holding company becomes an investment entity in the amended IFRS 10. Some constituents think that segment reporting will continue to apply because there was no consequential amendment to IFRS 8 when the Amendments were issued. Others opine that providing segment information would be incompatible with the fair value measurement basis, and may create a potential conflict between the financial statements and segment aggregated information. If indeed segment reporting is still applicable for an investment entity parent, it would be difficult to justify that investments in subsidiaries are made for the sole purpose of investment returns. Revenues, earnings, assets and liabilities must be consolidated for each reportable operating segment, and this may indicate that management is also directing substantive business activities for other returns. It also unclear how segment aggregated data totals can be reconciled to data totals in the financial statements because the measurement bases are different.

On 28 February 2013, the MASB issued *Investment Entities – Amendments to MFRS 10, MFRS 12 and MFRS 127* that are identical in all respects to the IASB's Amendments.

References:

1. Exposure Draft *Investment Entities – Proposed Amendments to IFRS 10, IFRS 12 and IAS 27*, 2011, IASB.
2. IAS 27 *Consolidated and Separate Financial Statements*, 2008, IASB.
3. IAS 27 *Separate Financial Statements*, 2011, IASB.
4. Investment Entities – *Amendments to IFRS 10, IFRS 12 and IAS 27*, 2012, IASB.
5. Investment Entities – *Project Summary and Feedback Statement*, 2012, IASB.
6. IFRS 8 *Operating Segments*, 2008, IASB
7. IFRS 10 *Consolidated Financial Statements*, 2011, IASB.
8. IFRS 12 *Disclosures of Interests in Other Entities*, 2011, IASB.
9. IFRS 13 *Fair Value Measurement*, 2011, IASB.

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