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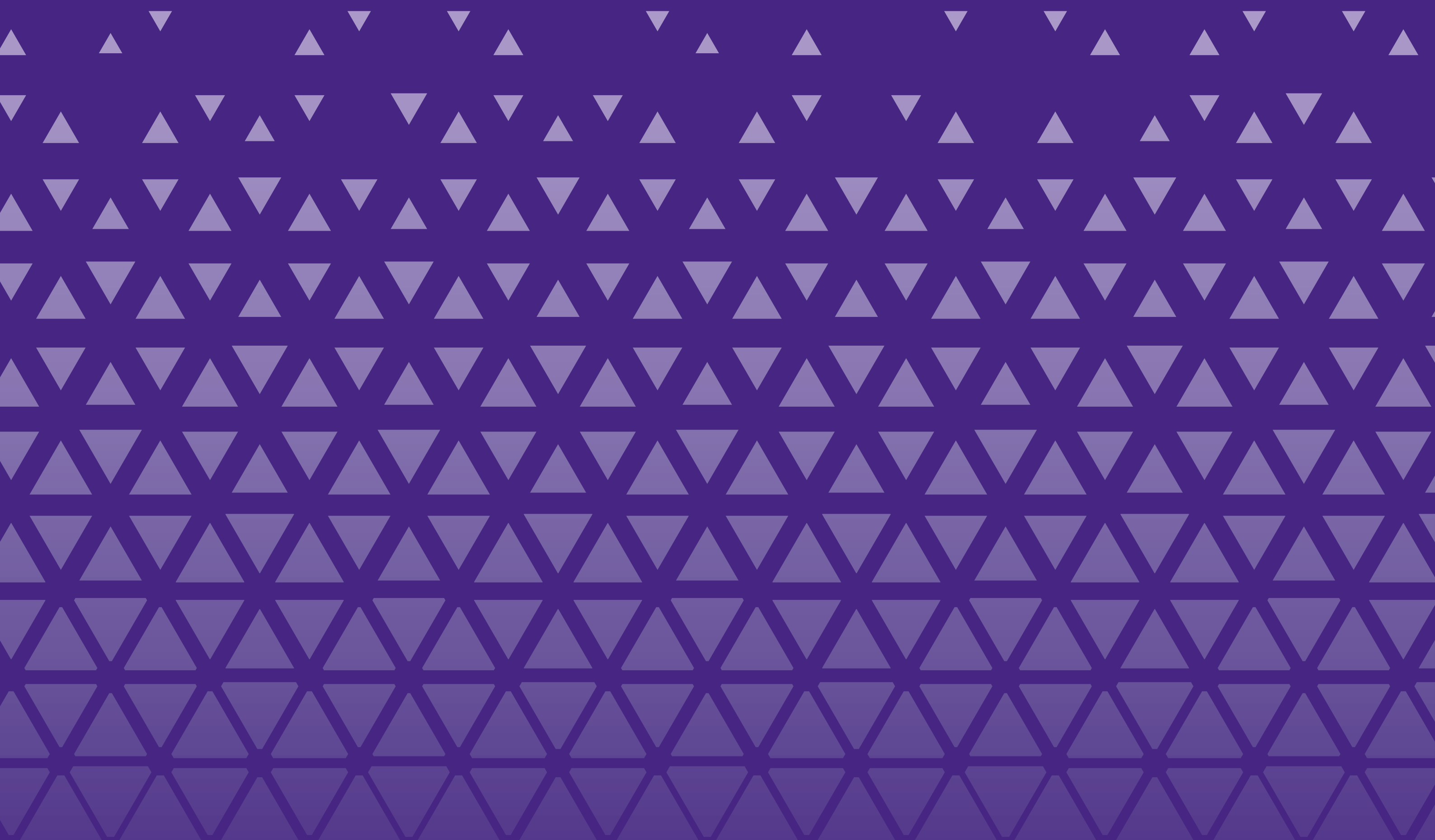
Investment entities



For many years, preparers and investors in the investment entity industry felt that consolidating the financial statements of an investment entity and its investees does not provide the most useful information. Consolidation made it more difficult for investors to understand what they are most interested in – the value of the entity's investments.

The IASB were influenced by these arguments. In October 2012, the IASB amended IFRS 10 to provide a limited scope exception from the consolidation guidance for a parent entity that meets the definition of an investment entity. The changes provided a definition of an investment entity together with detailed application guidance. Entities that meet the definition of an investment entity in accordance with IFRS 10, do not consolidate certain subsidiaries and instead measure those investments that are controlling interests in another entity (ie their subsidiaries) at fair value through profit and loss. This exception does not apply to subsidiaries which provide investment related services to the parent entity ('service subsidiaries') which will continue to be consolidated. This is a mandatory exception, not an optional one.

There were a number of implementation issues identified in applying this exception and therefore in December 2014 the IASB published amendments to the investment entity exception entitled 'Investment Entities: Applying the Consolidated Exception (Amendments to IFRS 10, IFRS 12 and IAS 28)' addressing these issues. These amendments are incorporated in the detail of this section.

Practical insight – number of entities affected

Many entities that fit the investment entity definition are nonetheless not impacted by the exception to consolidation because their investments are not subsidiaries. Investment entities that commonly hold controlling interests include venture capital and private equity groups, along with some 'master-feeder' and 'fund-of-funds' structures. Some pension funds and sovereign wealth funds may be impacted. Unit trust and mutual fund-type entities rarely hold controlling interests and therefore are normally less likely to be affected.

1.1 Definition of an investment entity

The definition of an investment entity is fundamental when determining if the exception should be applied. It has three components, accompanied by four 'typical characteristics'. Establishing whether an entity meets the definition of an investment entity is the central element to this exception, and could require significant judgement.

The definition, typical characteristics and their interaction are set out below:

Definition of an 'investment entity' [IFRS 10.27]

An investment entity is an entity that:

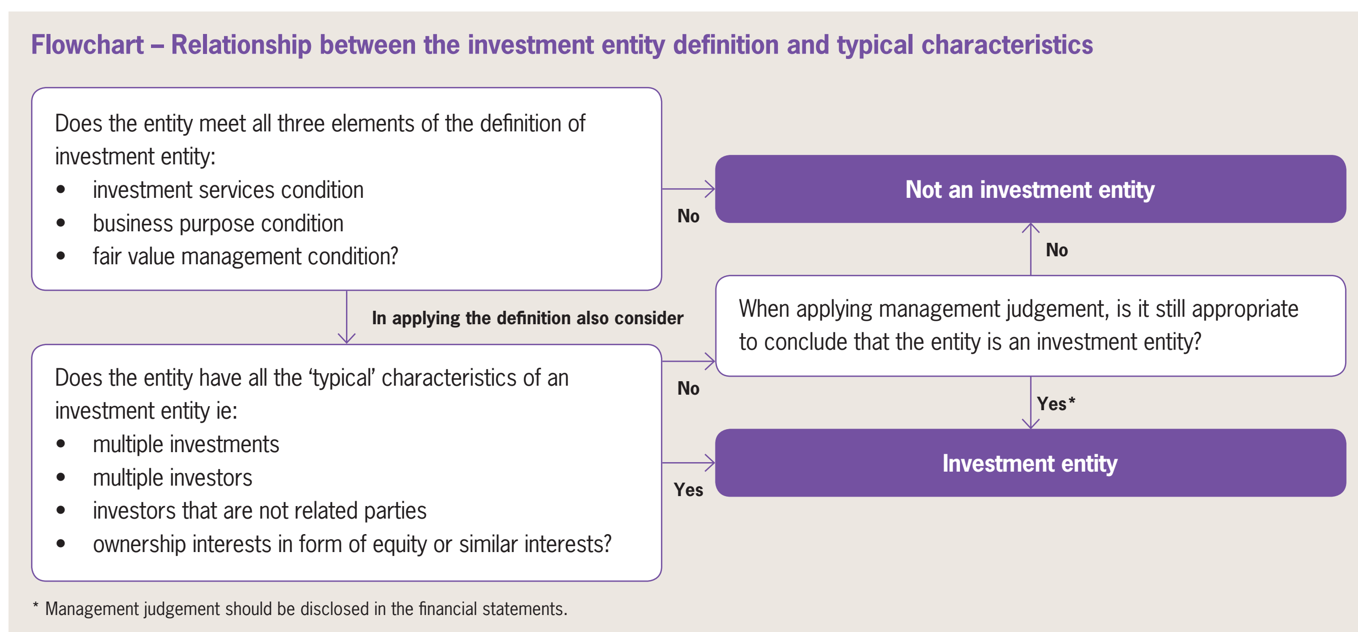
a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services (investment services condition)
b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or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

Typical characteristics [IFRS 10.28]

In assessing whether it meets the definition, an entity shall consider whether it has the following 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
d) it has ownership interests in the form of equity or similar interests.

In October 2012, the IASB amended IFRS 10 to provide a limited scope exception from the consolidation guidance for a parent entity that meets the definition of an investment entity.



Although the investment entity definition is paramount, most entities that meet that definition are also in general expected to have all four of these typical characteristics. If an entity lacks one or more of the characteristics additional judgement is required to assess whether it meets the definition. In our view it is very unlikely that an entity with none of the typical characteristics would meet the definition of an investment entity.[1]

IFRS 10 provides examples of situations in which the absence of a typical characteristic would not necessarily preclude the entity from being an investment entity. More detail on each of the characteristics together with these examples is provided below:

1.1.1 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].

Even though having more than one investment is typical of an investment entity, there may, however, be times when the entity has only one investment. This does not necessarily prevent an entity from meeting the definition of an investment entity; all facts and circumstances need to be taken into account. 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 (for example, when the required minimum investment is too high for an individual investor)
d) is in the process of liquidation [IFRS 10.B85P].

The intention of IFRS 10 is that generally an investment entity will have more than one investment and so therefore it is unusual for it to have only one investment for its entire period as an investment entity. Having one investment is typically only temporary.

If the investment entity only has one investment then it can still qualify as an investment entity, however this is not typical of an investment entity. Therefore management will need to apply and disclose their significant judgement made in reaching this conclusion.

[1] The IFRIC were asked to clarify whether an entity still qualifies as an investment entity if it possesses all three elements of the definition (IFRS 10.27) but none of the typical characteristics listed in IFRS 10.28.
At the time of writing, they have tentatively concluded that an entity that possess all three elements of the definition of an investment entity in IFRS 10.27 is an investment entity. This is the case even if that entity does not have one or more of the typical characteristics of an investment entity listed in IFRS 10.28. If an entity does not have one or more of the typical characteristics, it applies additional judgement in determining whether it possesses the three elements of the definition.

1.1.2 More than one investor

Usually, 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].

However, an investment entity may be formed by, or for, a single investor that represents or supports the interests of a wider group of investors (for example, a pension fund, government investment fund or family trust).

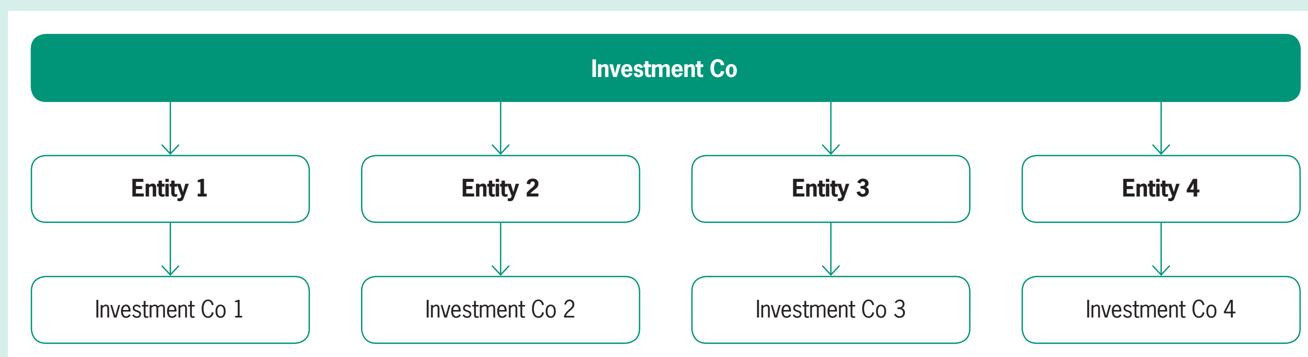
There may also be times when the entity temporarily has a single investor. For example, an investment entity may have one investor when the entity:

a) is within its initial offering period
b) has not yet identified suitable investors to replace those that have redeemed their interests
c) is in the process of liquidation.

If the entity only has one investor or that investor represents the interests of a wider group of investors then it can still qualify as an investment entity, however this is not typical of an investment entity. Therefore management will need to apply and disclose their significant judgement they make in reaching this conclusion.

Practical insight – Intermediate Holding Companies

Some group structures are set up for regulatory, tax or similar purposes and are wholly owned subsidiaries that own only one investment. In these cases it may be appropriate to consider the group structure as a whole. For example, this would apply to the following:



Investment Co is owned by a number of unrelated investors. Entities 1-4 have been set up purely for regulatory purposes and are wholly owned subsidiaries of Investment Co. They control only one investment. Entities 1-4 do not carry out any other activities.

Whilst individually Investment Co and entities 1-4 would be unlikely to qualify as investment entities because they do not display enough of the typical characteristics (only equity ownership interests), as a group however, they have all the typical characteristics of an investment entity. This is because the group has:

- more than one investment
- more than one investor
- unrelated investors
- equity ownership interests.

If therefore the group has the three conditions documented in the definition in IFRS 10.27 (investment services, business purpose and fair value) then all of entities 1-4 and Investment Co would be considered investment entities. This is because the purpose and design of the entities is purely to meet the regulatory requirements in the various jurisdictions.

1.1.3 Investors that are not related parties

Typically, an investment entity has several investors that are not related parties of either the entity or other members of its group. Having unrelated investors would make it less likely that the entity, or other members of its group, 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 or other related party investors, 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].

1.1.4 Ownership interests in the form of equity or similar interests

An entity is normally a separate legal entity; however this is not an explicit requirement. Ownership interests in an investment entity typically take the form of equity or similar interests (for example, 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].

Practical insight – regulated investment entities

In many countries investment services are subject to specific laws and regulations. Accordingly, certain entities are considered to be 'investment companies' or similar for the purpose of local law and regulation. This leads to a question as to whether these regulated entities should automatically be presumed to meet the definition of an investment entity.

The answer is no – the definition does not refer to any local regulatory requirements. The IASB concluded that referring to local legal definitions would not be appropriate in an international standard. Accordingly, an entity is not necessarily an investment entity under IFRS 10 simply because it is regulated. Conversely, an entity can be an investment entity under IFRS 10 even if not considered as such under local requirements. This differs to US GAAP, which specifies that an entity regulated under the SEC's Investment Company Act of 1940 would be an investment company for accounting purposes.

Typically, an investment entity has several investors that are not related parties of either the entity or other members of its group.

1.2 Applying the definition

In assessing whether an entity meets the definition, all facts and circumstances should be considered, including the entity's purpose and design [IFRS 10.B85A]. It will often be straightforward to determine whether an entity is an investment entity. However, in view of the fundamental importance this assessment has on affected entities' financial statements, IFRS 10 provides extensive application guidance.

More detail on each element of the definition is provided below:

1.2.1 Investment services condition

One of the essential activities of an investment entity is that it obtains funds from investors in order to provide those investors with investment management services. This is a feature that distinguishes investment entities and other entities, although not in isolation; other features need to be present for an entity to meet the definition of an investment entity.

1.2.2 Business purpose condition

The second part of the definition of an investment entity is that the entity has committed to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both [IFRS 10.27(b)].

Typically an entity's investment objectives (ie its business purpose) will be evidenced by documents such as:

a) the offering memorandum
b) publications distributed
c) other corporate or partnership documents.

Further evidence may include how the entity presents itself to third parties. An entity that presents itself as an investor whose objective is to jointly develop, produce or market products with its investees is not an investment entity [IFRS 10.B85B].

As well as its own investing activities, an investment entity may provide (directly or through a subsidiary):

a) investment-related services (for example, investment advisory services, investment management, investment support and administrative services) to third parties as well as to its own investors, even if those activities are substantial to the entity – on the condition the entity continues to meet the definition of an investment entity
b) management services and strategic advice to investees
c) financial support to investees (such as a loan, capital commitment or guarantee) [IFRS 10.B85C and D].

Activities b) and c) are only permitted if these activities are undertaken to maximise the investment return (capital appreciation or investment income) from its investees and do not represent a separate substantial business activity or a separate substantial source of income to the investment entity.

If an investment entity has a subsidiary (that isn't an investment entity) that provides investment related services or activities such as those mentioned above to the investment entity, the subsidiary should be consolidated.

Practical insight – mandatory requirement

It is not uncommon for entities meeting the definition to nonetheless have a preference for consolidation of an investment entity subsidiary. Arguments are sometimes made as to why subsidiary investments should not be consolidated. For example, people may question whether showing the investments as a single line in the consolidated financial statements provides useful information to investors. In particular they argue that such a treatment:

- results in intercompany items between the investment entity parent and the investment entity subsidiary not being eliminated. This means that
  - the consolidated financial statements may show a large intercompany debtor
  - the fair value of the investments will be affected not just by its investments but also by its creditor to the parent and any other financing
- means the values of the individual investments held by the subsidiary will not be shown
- means any external liabilities held by the subsidiary such as bank loans will not be shown (being merged into the overall fair value of the investment entity subsidiary).

However these reasons do not override the mandatory requirement not to consolidate the investment entity subsidiary.

What can preparers do?

Preparers of investment entity parent financial statements can assist users in understanding the information on investment entity subsidiaries and investments by providing additional information and disclosures. This can be in the form of pro-forma information on their investments. This would need to be described as additional disclosure not required by IFRS.

Exit strategy

The definition of an investment entity does not refer directly to exit strategies. However, the application guidance makes it clear that an investment entity does not plan to hold its investments indefinitely but instead holds them for a limited period [IFRS 10.B85F]. Accordingly, to meet the definition, an investment entity is required to have an exit strategy documenting how it plans to realise capital appreciation. The requirements allow some flexibility as to the scope and detail of that strategy, as noted in the following paragraphs.

Exit strategies should cover substantially all of an investment entity's equity investments, non-financial investments and debt investments that have the potential to be held indefinitely. Those debt investments that have a maturity date are already seen as having an exit strategy as there is no possibility of holding them indefinitely. As well as those investments that have an exit strategy by default through limited life, exit strategies also do not need to include investments in other investment entities that are formed in connection with the entity for legal, regulatory, tax or similar business reasons if those entities have an exit strategy for their investments.

An exit strategy need not address each individual investment but should identify potential strategies for different types or portfolios of investments. It should however include a substantive timeframe for exiting the investment. Exit mechanisms that are only put in place for default events, such as a breach of contract or non-performance, are not considered exit strategies for the purpose of this assessment.

Exit strategies can vary by type of investment. The application guidance in IFRS 10 provides some examples of how investment entities can exit:

- private equity securities – via IPO, trade sale of a business, placement, distributions to investors of ownership interests in investees and sales of assets, liquidation or sale in an active market
- publicly traded equities – selling the investment in a private placement or in a public market
- real estate investments – sale of the real estate through specialised property dealers or the open market.

Practical insight – what should an exit strategy contain?

Exit strategies should be documented and include the following:

- the type of investment (or portfolio of investments the strategy relates to)
- how exit of the investment will be achieved
- expected outcomes and results to be achieved before the strategy is exercised
- the timeframe involved
- value of the investment to be achieved on exit
- confirmation the board has approved the strategy.

Benefits from investees

An investment entity's business purpose is to invest funds solely for returns from capital appreciation, investment income, or both. By contrast, a non-investment holding company normally seeks to obtain a wider range of benefits from its subsidiaries and typically operates more as an integrated business in order to obtain these benefits. Accordingly, a non-investment parent typically has more involvement in its subsidiaries' operations and the subsidiaries typically have more involvement with each other.

IFRS 10 aims to capture this distinction by stating that an entity does not meet the business purpose component of the investment entity definition if it obtains (or has the objective of obtaining) benefits from its investees that are 'unavailable to parties unrelated to the investee'.

IFRS 10 provides guidance on particular types of benefits from and involvement with investee entities and whether they are compatible with an investing business model. Put broadly, the more involvement the entity has with its investees (and the investees have with each other), the less likely it is that the entity will qualify as an investment entity. Conversely, it will be easier to demonstrate an entity meets the business purpose part of the definition when investees are substantially autonomous and operate independently of the investment entity and one another. The table overleaf provides a summary of permitted and prohibited types of involvement with investees:

<table>
<tr><th>Permitted [IFRS 10.B85I and B85J]</th><th>Prohibited [IFRS 10.B85I and B85J]</th></tr>
<tr><td>The following benefits gained from investees are permitted for an investment entity:
• using an investment in an investee as collateral for borrowings
• intercompany trading between investees in the same industry, market or geographic area
• other intercompany transactions that:
– are on terms that would be available to parties unrelated to the entity, another group member or the investee
– are at fair value
– do not represent a substantial portion of the investee's or the entity's business activity, including business activities of other group entities.</td><td>The following benefits gained from investees are prohibited for an investment entity:
• the acquisition, use, exchange or exploitation of the processes, assets or technology of an investee
• disproportionate, or exclusive rights to acquire assets, technology, products or services of any investee (for example, holding an option to purchase an asset from an investee if development is deemed successful)
• joint or other arrangements between the investee and another group member to develop, produce, market or provide products or services
• provision by investee of financial guarantees or assets to serve as collateral for another group member's borrowings
• an option held by a related party of the entity to purchase an ownership interest in an investee
• intercompany transactions other than those in the 'permitted' column.</td></tr>
<tr><td>The following other involvement with investees is permitted for an investment entity:
• providing investees (directly or through a subsidiary) with:
– management and strategic services
– financial support such as a loan, capital commitment or guarantee
if such activities are undertaken to maximise returns from investments rather than being a separate business activity or income stream.</td><td>The following other involvement with investees is prohibited for an investment entity:
• provision of services to investees that represent a separate business activity or income stream.</td></tr>
</table>

In some cases meeting the business purpose element of the definition will be straight forward; ie. if the entity does not provide any additional services or gain any additional benefits other than those of capital appreciation and investment income. Others will be less so, for example, when the entity provides both investing activities, investment related services and has an involvement in the management or the financial support of the entity. The extent to which each of these activities are provided will vary entity by entity and therefore careful consideration of individual facts and circumstances will be needed. This is discussed further in the practical insight box below.

Practical insight – extent of involvement in the investees' activities

As noted above, management services, strategic advice to investees and financial support to investees are only permitted by an investment entity if they do not represent a separate substantial business activity or separate substantial source of income to the investment entity. What represents "substantial" and the extent of services provided will vary and judgement will be required to determine whether the entity is an investment entity or not. When the required judgement is considered significant, it should be disclosed in the financial statements as a critical accounting judgement.

It is important to consider the reason for the entity providing services other than investing activities as well as the quantum. Management should be questioning whether:

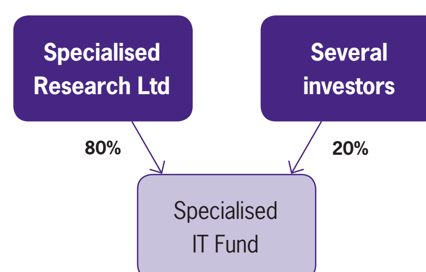
- the entity is likely to gain any other benefits other than capital appreciation and investment income
- how it presents itself to third parties. If the entity is a genuine investment entity, they will more likely discuss levels of investment returns rather than how the investment is performing in the other activities the entity is involved in.

In our view the level of involvement can be high as long as it is done with the aim to maximise the investees overall value in order to maximise capital appreciation. If there are other reasons for the involvement then this could result in the entity not being an investment entity.

As well as the above, entities must also remember to consider other prohibited activities, for example, having investments without exit strategies, and gaining significant benefits other than capital appreciation and investment income, as noted above.

Example – Specialised IT Fund (based on illustrative example 2 accompanying IFRS 10)

Specialised Research Ltd formed Specialised IT Fund, with the aim being to invest in IT start-up companies for capital appreciation. The group structure is as follows:



Specialised Research Ltd holds options to acquire investments held by Specialised IT Fund, at their fair value, which would be exercised if the IT systems produced by the investees would benefit the operations of Specialised Research Ltd.

Specialised IT Fund has not identified any exit plans with regards to its investments. An investment adviser manages Specialised IT fund, acting as an agent on behalf of the investors of the fund.

Is the fund an investment entity?

Conclusion

Specialised IT Fund is not an investment entity, despite its business purpose being investing for capital appreciation and the potential for investment income, because:

- Specialised Research Ltd could obtain additional benefits (as well as the capital appreciation and investment income), if the IT assets developed by the investees benefit the operations of Specialised Research Ltd (through the options exercisable by Specialised Research Ltd)
- Specialised IT Fund hold equity investments, which do not include exit strategies. Specialised IT Fund do not control the options held by Specialised Research Ltd and these are therefore not considered to be an exit strategy.

Practical insight – real estate investment entities

Real estate entities that own or lease investment property directly (ie that have no subsidiaries) are not affected by this exception. However, many real estate investment entities hold properties in separate legal entities (sometimes referred to as 'corporate wrappers'). These separate entities may include borrowings used to finance the property purchase. In such cases consolidation versus fair value measurement has a significant impact on the parent entity's reported financial position, even if the IAS 40 fair value model is used. Fair valuing the various separate legal entities will result in a net rather than gross balance sheet position and will also change reported net assets (due to the entities' debt being fair valued among other factors).

Determining whether a real estate entity meets the investment entity definition is therefore critical and has to be done on a case-by-case basis. In many cases it is readily apparent that a real estate entity fails the definition – for example, because it undertakes property development activities that are distinct from its investment activities. IFRS 10's illustrative examples include a case in which an entity is not considered an investment entity for various reasons including that it 'has a separate substantial business activity that involves the active management of its property portfolio, including lease negotiations, refurbishments and development activities, and marketing of properties to provide benefits other than capital appreciation, investment income, or both'.

Other factors to consider include:

- whether or not the real estate entity has an exit strategy for its properties or portfolios of properties, including a substantive timeframe for exit
- the extent to which the real estate entity uses fair value as its primary performance measure. Even if an entity applies the IAS 40 fair value model, it may use other measures to assess performance and to make investment decisions, such as information about expected cash flows, rental revenues and expenses.

1.2.3 Fair value condition

The last element of the definition is that an investment entity measures and evaluates the performance of substantially all of its investments on a fair value basis. This is because 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:

- provides investors with fair value information
- measures substantially all of its investments at fair value in its financial statements whenever fair value is required or permitted in accordance with IFRSs (for example, uses fair value alternatives in IAS 28, IAS 40, IFRS 9)
- uses fair value as the primary basis for reporting internally to key management personnel [IFRS 10.B85K].

Practical insight – 'substantially all'

IFRS 10 does not define 'substantially all'. Therefore assessing whether an entity meets this element will require judgement. The IASB does not provide any bright lines (for example, a level or a percentage). In our view if an entity genuinely considers itself to be an investment entity then it would have selected the fair value option for their investments, as the fair value option provides more meaningful information to investors. If the entity has a significant investment measured at cost then it is unlikely to meet the fair value element of the definition.

An investment entity may have some non-investment assets, such as a head office property and related equipment, and may also have financial liabilities. The fair value measurement element of the definition of an investment entity in IFRS 10.27(c) applies to an investment entity's investments. Therefore, an investment entity need not measure its non-investment assets or liabilities at fair value.

1.3 Accounting treatment for an investment entity

1.3.1 Accounting by an investment entity

The accounting requirements in IFRS 10 for investment entities are limited to an exception from consolidation of investments in certain subsidiaries. The exception also impacts the separate financial statements of an investment entity (if these are prepared). The table summarises the key requirements:

Requirement	Details
Accounting for subsidiaries held as investments	• subsidiaries held as investments are measured at fair value through profit or loss in accordance with IFRS 9 instead of being consolidated [IFRS 10.31]. This accounting is mandatory not optional. Voluntary consolidated financial statements that state compliance with IFRS are not permitted • IFRS 3 does not apply to the obtaining of control over an exempt subsidiary • the consolidation exception also applies to controlling interests in another investment entity.
Accounting for service subsidiaries	• an investment entity is still required to consolidate subsidiaries that are not themselves investment entities and whose main purpose and activities are providing services that relate to its investment activities [IFRS 10.32] • IFRS 3 applies on obtaining control over a service subsidiary.
Accounting in separate financial statements	• an investment entity's fair value accounting for its controlled investees also applies in its separate financial statements [IAS 27.11A] • if the consolidation exception applies to all an investment entity's subsidiaries throughout the current and all comparative periods (ie it has no services subsidiaries) its separate financial statements are its only financial statements [IAS 27.8A].

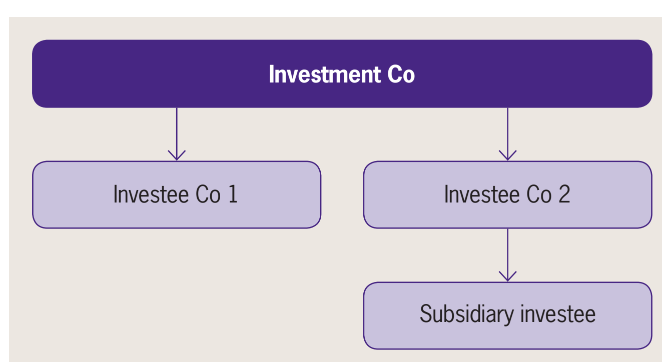
Accounting for subsidiaries held as investments

Except for subsidiaries required to be consolidated under IFRS 10.32 (see section on accounting for service subsidiaries overleaf), an investment entity shall not consolidate its subsidiaries or apply IFRS 3 when it obtains control of another entity. Instead subsidiaries held as investments are measured at fair value through profit and loss in accordance with IFRS 9.

An investment entity is not required to produce consolidated financial statements if all of its subsidiaries are required to be measured at fair value through profit or loss (see section on discussion of separate financial statements).

Indirect subsidiaries

When accounting for subsidiaries that have subsidiaries of their own, the investment entity accounts only for the fair value of its direct subsidiary. This fair value would include the fair value of those entities the direct subsidiary controls (ie the indirect subsidiaries). This is demonstrated in the following group structure:



In the above example, Investment Co would account for the fair value of both Investee Co 1 and Investee Co 2; the fair value of the subsidiary investee would be taken into account in the fair value of Investee Co 2.

Accounting for service subsidiaries

Practical insight – what are service subsidiaries?
Service subsidiaries are:
- not investment entities themselves
- entities whose main purpose and activity is providing services relating to investment activities.

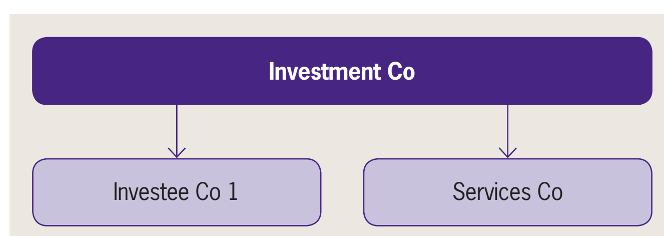
IFRS 10 does not provide a definition of these 'services', however refers to the guidance in IFRS 10.B85C-E for examples. These are services or activities such as:
- investment advisory services
- investment management
- investment support
- administrative services
- management services and strategic advice to investees
- financial support to investees (such as a loan, capital commitment or guarantee).

This list in not considered exhaustive and the services can be provided to the entity or to other parties.

Investment entities are allowed to perform these services and still meet the definition of an investment entity under the conditions noted. However service subsidiaries are not themselves investment entities and so the consolidation exception will not apply. This is an important consideration and one which was clarified when the IASB published the amendments to the investment entity exception in December 2014.

In our view, only subsidiaries that have a clear purpose of providing services relating to investing activities which are a substantial part of their business should be consolidated.

If an investment entity has subsidiaries that are not themselves investment entities and whose main purpose and activities are providing services that relate to its investment activities, the investment entity must consolidate these in accordance with the requirements of IFRS 10. In addition, IFRS 3 needs to be applied to acquisitions of these subsidiaries [IFRS 10.32]. This requirement is demonstrated in the following group structure:



Services Co provides investment support and administrative services to the group. Investment Co would therefore consolidate Services Co and account for Investee Co 1 at fair value through profit or loss.

In the above example, the accounting is clear, however, there can be some judgement required in determining whether or not a subsidiary is a service subsidiary.

Practical insight box: Tax optimisation – is this an investment-related service?
The IFRS Interpretations Committee (IFRIC) were asked to clarify whether the activities carried out by wholly-owned intermediate subsidiaries that have been established to minimise the tax paid by investors in the investment entity parent should be considered to be investment-related services or activities. In the fact pattern presented to the IFRIC, the intermediate subsidiaries themselves had no other activity other than tax optimisation.

The following extract from the IFRIC Update in March 2014 records the agenda decision taken:

'The Interpretations Committee noted that, according to paragraph BC272 of IFRS 10, the IASB thinks that fair value measurement of all of an investment entity's subsidiaries would provide the most useful information, except for subsidiaries providing investment-related services or activities. In addition, the Interpretations Committee noted that the IASB had considered requiring an investment entity to consolidate investment entity subsidiaries that are formed for tax purposes, but had decided against this.

The Interpretations Committee noted that one of the characteristics of 'tax optimisation' subsidiaries described in the submission is "that there is no activity within the subsidiary". Accordingly, the Interpretations Committee considers that the parent should not consolidate such subsidiaries, because they do not provide investment-related services or activities, and do not meet the requirements to be consolidated in accordance with paragraph 32 of IFRS 10. The parent should therefore account for such an intermediate subsidiary at fair value.

On the basis of the analysis above, the Interpretations Committee considered that in the light of the existing IFRS requirements, neither an interpretation nor an amendment to a Standard was necessary and consequently decided not to add the issue to its agenda.'

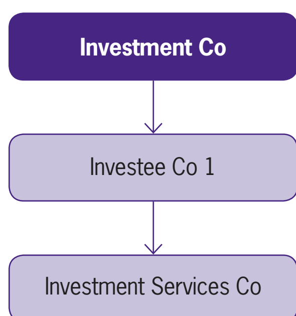
Accounting in separate financial statements

An investment entity's separate financial statements are its only financial statements if all of its subsidiaries are required to be measured at fair value through profit or loss for the current period and all the comparative periods presented. A parent that is an investment entity does not present consolidated financial statements if it is required by IFRS 10.31 to measure all of its subsidiaries at fair value through profit or loss (IFRS 10.4B).

There is also an exemption for an intermediate parent from preparing consolidated financial statements if its parent produces financial statements, in which subsidiaries are consolidated or measured at fair value through profit or loss in accordance with IFRS 10. The following two examples demonstrate how this exemption can apply to investment entity intermediate parent companies.

Example – intermediate parent is an investment entity

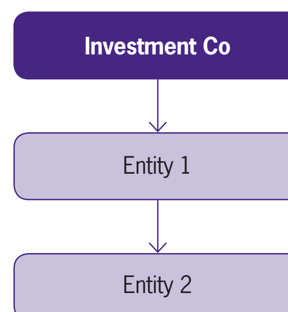
In the following example, Investee Co 1 is an investment entity and Investment Services Co provides investment related services or activities to the group:



In this example, you would expect Investee Co 1 to consolidate Investment Services Co and Investment Co to apply the consolidation exception and include Investee Co 1 at fair value through profit or loss. However, the intermediate parent is allowed to take the exemption from preparing consolidated financial statements in IFRS 10.4(a)(iv), as long as it meets the conditions described in IFRS 10.4. When preparing its separate financial statements, Investee Co 1 could account for its investment in Investment Services Co at either cost or fair value as an accounting policy choice.

Example – intermediate parent is not an investment entity

In the below structure, Investment Co is an investment entity that has a controlling interest in Entity 1 (which itself controls Entity 2). Entity 1 and Entity 2 are not investment entities or entities that provide investment related services.



As mentioned above, under IFRS 10.1(a)(iv), a parent entity is exempted from preparing consolidated financial statements if it meets certain criteria. One of those criteria is that: "its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs". The IASB have clarified (through the amendments to the investment entity exemption issued in December 2014) that this exemption is also available to parent entities that are subsidiaries of investment entities where the investment entity measures its investments at fair value in accordance with IFRS 10.31.

Accounting for other investments of an investment entity

Investment entities may hold, in addition to controlling interests in other entities, investments in associates, other equity investments, debt assets and investment property. The investment entity exception does not directly affect the accounting for these other investments. However, in order to qualify as an investment entity these other investments will have to be fair-valued wherever required or permitted by IFRSs. Accordingly, the entity would apply:

- for associates the option in IAS 28.18 that permits a 'venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds' to measure associates and joint ventures at fair value through profit or loss in accordance with IFRS 9
- for investment property, the fair value model in IAS 40.

Other equity and debt investments are covered by IFRS 9. When IFRS 9 is applied, the entity would measure debt investments that are managed on a fair value basis at fair value through profit or loss. It is expected that investment entities would manage their investments on such a fair value basis, although they might also have some financial assets that are not 'investments'. Other equity investments would also be measured at fair value, although the entity could elect for fair value through other comprehensive income (which would not preclude investment entity status).

For entities that still apply IAS 39 'Financial Instruments: recognition and measurement', IAS 39's 'fair value' option would need to be elected to achieve this outcome for many debt investments. The IAS 39 fair value option is available in particular circumstances, including for assets that are managed on a fair value basis. This designation must be made on initial recognition and is then irrevocable in most circumstances. Other equity investments would be treated as available-for-sale and measured at fair value through other comprehensive income, unless the fair value option is used.

1.3.2 Accounting by a non-investment entity parent or investor of an investment entity

Accounting by non-investment entity parents of investment entity subsidiaries, associates and joint ventures will continue to be consolidated in the usual way. However, there can be complexities with how to account for subsidiaries, associates and joint ventures of direct investment entity subsidiaries and these are explained in this section.

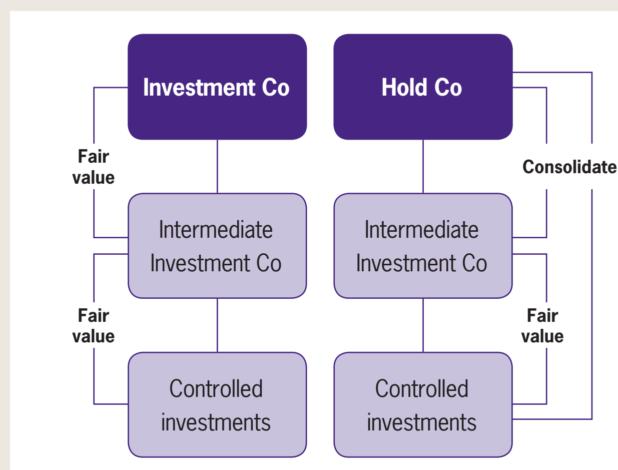
Accounting by the parent of an investment entity

A (non-investment) parent entity of an investment entity will continue to consolidate its subsidiaries in the normal way, including any subsidiaries of the investment entity sub-parent. Put another way, the consolidation exception for an investment entity parent does not carry forward into the consolidated financial statements of its higher level parent unless that higher parent is also an investment entity.

Accordingly, investment entity sub-parents will need to perform fair value measurements for the purpose of their own financial statements and also provide consolidation information (for example, a consolidation package) for their higher-level parent's group financial statements. This is illustrated in the following example:

Example – non-investment parent entity accounting

Consider the two group structures illustrated below. Both structures include investment entity sub-parents, which have controlling interest investments in other companies. The first group is headed by Investment Co, which is an investment entity and the second by Hold Co which is not an investment entity.



Application of requirements

For the Investment Co (left-hand) group:

- Intermediate Investment Co will account for its controlled investments at fair value
- Investment Co will also account for its investment in Intermediate Investment Co at fair value.

For the Hold Co (right-hand) group:

- Intermediate Investment Co will account for its controlled investments at fair value
- Hold Co must consolidate Intermediate Investment Co and its controlled investments.

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