

Investment company technical release

September 2011

Proposed exemption from consolidation for investment entities

The consolidation controversy

Of all the accounting issues with which investment companies have had to contend, the requirement under accounting standards to consolidate any portfolio holdings controlled by the parent under all but the most unlikely scenarios, has been one of the most contentious. Investment companies have had no option other than to present group accounts in almost all such circumstances, and even though the group accounts may be supplemented by pro-forma fair value information or accounts of the parent company, there have always been concerns over the usefulness of accounts which allow information on the trading activity of a small number of investee companies to distort the reported investment performance of the fund.

As recently as 2008, in ED 10 'Consolidated Financial Statements', the IASB continued to remain firmly against any consolidation exemption for investment entities. Following continued lobbying however and discussion with the FASB in the United States (where there is an existing exception) the IASB has softened its stance and has now published an exposure draft (ED/2011/4) setting out the terms of a proposed exemption.

Overview of the proposals

The proposals revolve primarily around the definition of an investment entity, and the key features are that:

- an entity which qualifies as an investment entity would be exempt from consolidating its accounts with those of a subsidiary
- to qualify, an investment entity must meet six detailed criteria
- an investment entity would be required to account for subsidiaries at fair value through profit or loss

- in future it would also be necessary to qualify as an investment entity in order to be permitted under IAS 28 to measure investments in associates at fair value through profit or loss
- additional disclosure requirements would be introduced.

Details of the six criteria which must be met in order to achieve investment entity status are discussed in more detail in the appendix to this technical release. In summary, issues for debate are likely to include:

- the circumstances under which non-investment activities could cause an entity to fail the definition
- the application of the guidance where an entity controls entities which provide it with investment services or form part of its investment activities
- the practical application of the requirement for an investment entity to have identified potential exit strategies and documented these
- the application of the guidance to entities which have a small number of investors
- whether the new provisions should only be applied prospectively when implementing them for the first time.



The IASB proposals represent a significant step forward in that for the first time there is an opportunity to debate a potential solution to an issue which has caused some investment companies financial reporting difficulties over many years. The exposure draft is however likely to generate considerable debate, not least because opinions on the proposals within the IASB are divided and there is a larger than normal number of dissenting views published as part of the consultation. Attempts by the IASB to ensure that the exemption will not be open to abuse have inevitably led the proposed rules to contain some areas of complexity. The inherent subjectivity in a number of the criteria which define an investment entity may be an issue to those who are concerned most with their possible misuse, but it is to be hoped that such concerns will not ultimately stand in the way of a standard being issued in final form once the consultation has run its course.

Companies will need to consider the potential impact of the proposed requirements according to their specific circumstances. Whether an investment company achieves investment entity status (as defined) will have an impact, not only on the treatment of any controlled investees, but also on the company's ability to reflect holdings in associates at fair value under IAS 28. Thus even companies with no controlled investees would be advised to consider their position if they currently make use of the existing IAS 28 exemption.

At this stage the only proposals on the table are in relation to IFRS. Following recent changes in the ASB's proposed three tier framework for UK GAAP, it is becoming increasingly difficult to speculate on the precise future shape of UK GAAP for investment companies. If, however, at the end of the day an IFRS consolidation exemption is put in place, UK GAAP might reasonably be expected to consider following suit. In the meantime, boards and managers wishing to comment on the proposals have until 5 January 2012 to submit their views to the IASB.

Overall the proposals to remove the consolidation burden for most investment entities are a welcome development. For some it may add uncertainty around whether they will meet the qualifying criteria and all entities wishing to benefit from the exemption will need to examine them closely.



Contact us

If you would like to discuss any of the matters raised in this release further, please contact one of our investment trust experts listed below.



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Appendix – Further discussion of the IASB’s proposals

Defining an investment entity

The six criteria, all of which must be met to qualify as an investment entity, are set out below. Compliance with these criteria requires to be assessed on an on-going basis, as an entity which ceases to meet these will no longer be eligible for the exemption.

- 1 Nature of investment activity – the nature of the entity is such that its ‘only substantive activities’ are investing in multiple investments for capital appreciation, investment income or both
- 2 Business purpose – the entity’s business purpose must be investing for capital appreciation, investment income or both and the entity must make an explicit commitment to investors to this effect
- 3 Unit ownership – ownership in the entity must be represented by units of investments (eg shares or partnership interests) to which proportionate shares of net assets are attributed
- 4 Pooling of funds - the entity pools investors’ funds so that they can benefit from professional investment management
- 5 Fair value management – substantially all of the entity’s investments are managed and evaluated on a fair value basis
- 6 Investor information – the entity provides information about its investment activities to its investors

An investment entity should not consolidate the entities it controls but should instead measure them at fair value through profit or loss. There is an important exception to this however which is intended to cover the situation where a controlled entity provides services that relate ‘only to the [investment] entity’s own investment activities’. In these circumstances the investee is required to be consolidated. This would not cause the parent to lose its investment entity status and therefore it would still be exempt from consolidating other entities which it controls.

The investment company industry may need to consider how this is to be interpreted, in particular whether the proposals cater adequately for situations where for example an investment company owns a dealing subsidiary or has a controlling interest in a special purpose entity.

Nature of investment activity

This criterion requires the investment entity to have no ‘substantive’ activities other than its investment activities. Much of the debate on the exposure draft is likely to revolve around the extent to which activities carried out in

conjunction with investment activities could cause an entity to fail this somewhat subjective test. The IASB indicate that if an entity is able to obtain benefits from any of its investees which are not available to other investors (and thus not simply related to capital appreciation/investment income) then this would not be consistent with investment entity status. First impressions however are that this looks to be an area where there may be calls for the guidance to be expanded.

There is specific provision to deal with the situation where an investment entity takes control of collateral which is unrelated to its investment objectives, as a result of defaults related to its investments. The exposure draft suggests that if an investment entity temporarily holds such assets (and related liabilities) this does not affect its investment entity status provided that the investment entity did not acquire the investment with the intention of controlling the collateral.

The requirement that the investment entity must hold ‘multiple investments’ is also significant – in its simplest form an investment entity holding a number of investments directly at the same time would clearly meet this criterion. For many typical investment companies this would be consistent with holding a diversified portfolio but there may be circumstances in a fund’s life cycle (for example, on launch or wind down) where this may not be possible and these circumstances are recognised in the proposals, which is helpful.

The question of multiple investments is particularly pertinent to master/feeder fund structures and the proposals do specifically permit the holding of multiple investments indirectly through another investment entity. Thus it is envisaged that feeder funds would not necessarily fail the multiple investments criterion purely as a result of having invested via a master fund. Having said that the precise structure in question would have to meet all the other criteria.

Business purpose

Business purpose could be evidenced in for example a fund’s prospectus and its statement of investment objectives and policies, and for the typical investment company demonstrating that it has made an explicit commitment to investors appears unlikely to be too problematic.

A key issue related to business purpose arises in relation to exit strategies for investments. The application guidance states that as part of being able to evidence its business purpose, an investment entity should have identified potential exit strategies dealing with how it plans to realise its investments and that these should be documented. Whilst admittedly this principle does help to differentiate an investment entity from a company seeking to operate subsidiaries indefinitely to secure returns from their activities, there may be debate as to the level of granularity required in making an exit strategy assessment and what adequate documentation would look like in practice.

Unit ownership

At first glance the concept of unit ownership seems relatively straightforward and seems to embrace a typical investment company structure where net asset value per share is the critical measure of the investor's interest in the fund.

The application guidance deals only very briefly with the issues posed by multiple share classes. It suggests that the existence of multiple classes of equity does not prevent an entity from being an investment entity, which is helpful, but it is silent on the impact of non-equity shares, or indeed situations where there is no equity at all.

Pooling of funds

As with unit ownership, the concept of pooling funds to benefit from professional investment management appears at first sight to be relatively uncontroversial. The complexity with this particular criterion lies in the fact that the proposals seek to place restrictions on the nature of the relationship between the investment entity and its investors.

In order to meet the definition of an investment entity, the entity must have investors that are unrelated to any parent which might exist and they must hold in aggregate a significant ownership interest. For the typical listed investment company with a significant proportion of its shares in the hands of the public this may not cause excessive difficulties. There is no minimum number of investors specified but clearly the aim of this requirement is to prevent the inappropriate creation of investment entities within larger corporate structures. Where an investment entity is controlled by another entity which is not itself another investment entity, the proposals will require the non-investment parent to consolidate any subsidiaries owned by the investment entity – ie the consolidation exemption available to the investment entity will not automatically pass on up the chain.

Once again, special considerations apply to master/feeder structures – the guidance indicates that whilst a master fund would not necessarily fail the pooling criterion by virtue of having a single feeder formed in conjunction with it, consideration may also need to be given to the feeder fund's own investors as part of the overall assessment of the structure.

Fair value management and investor information

The requirement to manage and evaluate performance on a fair value basis applies to substantially all of the entity's investments and in particular it applies to all controlled investments which may be held. Performance evaluation on

a fair value basis is required both in relation to internal and external reporting and in order to further characterise the external reporting aspects there are general requirements to enable investment activities to be evaluated. Examples of disclosures are set out in the application guidance and include:

- a reconciliation of opening and closing NAV per share
- income and expense ratios
- total return information
- details of funding commitments made by owners.

Furthermore, investment entities are required to disclose certain specific information relating to their controlled investees, including:

- name, country of incorporation and % ownership interest held
- details of any non-contractual support provided or intended (financial or otherwise)
- details of any significant restrictions on the ability of investees to transfer funds.

In addition to the above, there will be various consequential disclosures required which stem from other accounting standards. IFRS 7 for example contains the disclosures relating to fair value which will become applicable if there are now investments which were not previously held at fair value. On the other hand, some of the IFRS 7 risk disclosures may become more straightforward if there is no longer any consolidation required.

As was expected, there is no requirement in the exposure draft to disclose any summarised financial information or extract information from published accounts for significant controlled holdings. It should be noted however that IAS 24 related party disclosures will still continue to be applicable.

First year implementation

The current proposal is that where an entity meets the definition of an investment entity, the provisions should be applied prospectively. The reason given for this is that fair value information may not be available for controlled investees retrospectively. This may be a point for debate however given that investment companies managing investments on a fair value basis may well have had fair value information available or accessible. On balance it might perhaps have been preferable to have given companies the option of retrospective application in situations where the relevant information is readily available.



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