

HKFRS / IFRS UPDATE 2012/12

INVESTMENT ENTITIES – AMENDMENTS TO HKFRS 10, HKFRS 12 AND HKAS 27



Overview

On 31 October 2012 the International Accounting Standards Board (IASB) issued *Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)* which introduces an exception to the principle that all subsidiaries shall be consolidated.

The HKICPA followed the IASB's decision and on 12 December 2012 published amendments to HKFRS 10, HKFRS 12 and HKAS 27 which are textual copies of the amendments to IFRSs.

The amendments define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in its consolidated and separate financial statements. They also introduce disclosure requirements for investment entities into HKFRS 12 and amend HKAS 27.

Entities are required to apply the amendments retrospectively for annual periods beginning on or after 1 January 2014. Earlier application is permitted in order to allow investment entities to apply the amendments at the same time they first apply the rest of HKFRS 10.

An investment entity is an entity whose business purpose is to make investments solely for capital appreciation, investment income, or both, and that evaluates the performance of those investments on a fair value basis. The IASB thinks that the most common types of investment entity will be private equity organisations, venture capital organisations, pension fund, sovereign wealth funds and other investment funds.

The amendments result from proposals contained in an Exposure Draft (ED) published in August 2011. The project was undertaken jointly by the IASB and the FASB in the hope of achieving as similar guidance as possible. While the boards reached many common decisions, as a result of an initial scope difference, and other jurisdictional differences, the boards came to different decisions in a number of areas.

The ED proposed that in order to qualify as an investment entity, an entity would need to meet six specified criteria. These criteria were based on guidance in US GAAP. In response to the comments from respondents, including that the criteria as drafted would inappropriately include or exclude various structures, the IASB decided to provide a definition of an investment entity based on some of the criteria originally proposed in the ED. The remaining criteria represent typical characteristics of an investment entity and have been included to help entities determine whether they qualify as an investment entity. If an entity does not display one or more of the typical characteristics, it indicates that additional judgement is required in determining whether the entity meets the definition of an investment entity. An entity that does not have one or more of the typical characteristics would be required to disclose how it still meets the definition of an investment entity.

STATUS

Final

EFFECTIVE DATE

1 January 2014 with earlier application permitted

ACCOUNTING IMPACT

May be significant

The ED also proposed to remove the fair value option from IAS 28 *Investment in Associates and Joint Ventures* and to instead introduce a requirement for investment entities to measure their interests in joint ventures and associates at fair value through profit or loss. However IAS 28 has not been amended and the fair value option for venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds, has been retained. In retaining this option the IASB has noted that, to meet the definition of an investment entity, an entity must elect the fair value option in IAS 28 for any investments in associates or joint ventures.

Definition of an investment entity

An investment entity is an entity that meets all of the following criteria (the definition):

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

In assessing whether it meets the definition an entity is required to consider whether it has the following typical characteristics of an investment entity:

- It has more than one investment
- It has more than one investor
- It has investors which are not related parties of the entity
- It has ownership interests in the form of equity or similar interests.

Not meeting one or more of the typical characteristics does not preclude an entity from being an investment entity. However, it does indicate that additional judgement is required in determining whether the entity meets the definition of an investment entity. Accordingly, an investment entity that does not meet one or more of the typical characteristics is required to disclose the reasons for concluding that it is nevertheless an investment entity (see disclosures below).

An entity will not be disqualified from qualifying as an investment entity simply because:

- It provides investment-related services (eg investment advisory services, investment management, investment support and administrative services), either directly or through a subsidiary, to third parties as well as to its investors, even if those activities are substantial to the entity.
- If it provides management services, strategic advice and financial support to an investee, directly or through a subsidiary, but only 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.

Exception to consolidation

Other than as noted below, an investment entity is prohibited from consolidating its subsidiaries or applying HKFRS 3 *Business Combinations* when it obtains control of another entity. Instead, an investment entity is required to measure its subsidiaries at fair value through profit or loss in accordance with HKFRS 9 or HKAS 39 if HKFRS 9 has not yet been applied. The subsidiary would also be measured at fair value through profit or loss in the investment entity's separate financial statements.

An investment entity should consolidate subsidiaries that provide services that relate only to the investment entity's own investment activities and apply the requirements of HKFRS 3 to the acquisition of any such subsidiary. For example subsidiaries that provide investment-related services to third parties as well as to its investors or management services, strategic advice and financial support to an investee.

Under the amendments (but not the FASB's), a non-investment entity parent of an investment entity is required to consolidate all subsidiaries that it controls, including those controlled by and measured at fair value in the investment entity. The parent entity of an investment entity is only exempt from the consolidation requirement if the parent entity qualifies as an investment entity itself.

Application guidance

An entity is required to consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. The amendments add additional application guidance to HKFRS 10 describing the three elements of the definition and the four typical characteristics.

The entity commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both.

Evidence of the entity's business purpose includes documents such as an offering memorandum, publications and other corporate/ partnership documents relating to the entity's investment objectives or the way the entity presents itself to other parties such as potential investors or investees.

An entity that has a business purpose inconsistent with that of an investment entity will not meet the definition (see example 3). For example an entity whose objective is to jointly develop, produce or market products with its investees has a business purpose inconsistent with that of an investment entity because the entity will earn returns from the development, production or marketing activity in addition to returns from its investment.

Exit strategies and business purpose

One feature that differentiates an investment entity from other entities is that it does not plan to hold its investments indefinitely; it holds them for a limited period and has an exit strategy to realise capital appreciation from substantially all of its equity investments, non-financial asset investments (eg investment property) and any debt instruments that have the potential to be held indefinitely.

This does not mean that there is a requirement to have a specific exit strategy for each individual investment but there should be different potential strategies for different types or portfolios of investments. The strategies should include a substantive time frame for exiting the investments. 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 this purpose.

The guidance includes a number of examples for exit strategies.

An investment entity parent may have an investment in another investment entity subsidiary. The investment entity parent need not have an exit strategy for that investment, provided that the investment entity subsidiary has appropriate exit strategies for its investments (see example 4 below).

Earnings from investments are solely returns from capital appreciation, investment income, or both

This requirement is not met if the entity or another member of the group containing the entity obtains, or has the objective of obtaining, other benefits from the entity's investments that are not available to other parties that are not related to the investee (see example 2 below).

Examples would include:

- Acquiring, using, exchanging or exploiting of the processes, assets or technology of an investee or having disproportionate, or exclusive, rights to acquire assets, technology, products or services of any investee
- Joint arrangements (as defined in HKFRS 11) or other agreements between the entity or another group member and an investee to develop, produce, market or provide products or services

- Financial guarantees or assets provided by an investee to serve as collateral for borrowing arrangements of the entity or another group member (an investment entity would still be able to use an investment in an investee as collateral for any of its borrowings)
- An option held by a related party of the entity to purchase, from that entity or another group member, an ownership interest in an investee of the entity
- Transactions between the entity or another group member and an investee that:
 - Are on terms that are unavailable to unrelated parties, that are not at fair value or that represent a substantial portion of one of the parties' business activity.
 - An entity is not disqualified from being an investment entity merely because it has a strategy to invest in more than one investee in the same industry, market or geographical area in order to benefit from synergies that increase the capital appreciation and investment income from those investees and those investees trade with each other.

Substantially all of the entity's investments are measured and performance evaluated on a fair value basis

A distinguishing characteristic of an investment entity is that fair value results is the most relevant information for evaluating performance, both for investors and for management. An investment entity is required to report fair value information to investors and to key management personnel (as defined in HKAS 24 *Related Party Disclosure*). Key management personnel is expected to use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

An investment entity is also required to measure substantially all of its investments at fair value whenever fair value is required or permitted in accordance with HKFRSs. For example:

- Investment property (Fair value model in HKAS 40)
- Associates and joint ventures (Exemption from equity method in HKAS 28)
- Financial assets (HKFRS 9/ HKAS 39).

The fair value requirement only applies to investments. Non-investment assets (eg head office property and related equipment) and financial liabilities are not required to be measured at fair value.

Typical characteristic - More than one investment

An investment entity will usually hold several investments in order to diversify risks and maximise returns. These can either be held directly or indirectly (eg through another investment). However, an investment entity will not be required to hold multiple investments at all times throughout its existence.

Situations in which holding a single investment does not preclude an entity being an investment entity include:

- The entity is in its start-up period, has not identified suitable investments and, therefore, has not executed its investment plan (see example 1 below)
- Investments disposed of have not yet been replaced
- The entity is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (eg when the required minimum investment is too high for an individual investor)
- The entity is in the process of liquidation.

Typical characteristic - More than one investor

An entity that has more than one investor is less likely to obtain benefits other than capital appreciation or investment income from its investments. However the IASB acknowledges that sometimes an investment entity may have a single investor, these include:

- An investment entity formed by, or for, a single investor that represents or supports the interests of a wider group of investors (eg a pension fund, government investment fund or family trust)
- Times when an entity temporarily has a single investor:
 - The entity is within its unexpired initial offering period and is actively identifying suitable investors
 - The entity has not yet identified suitable investors to replace ownership interests that have been redeemed
 - The entity is in the process of liquidation.

Typical characteristic - Unrelated investors

Having investors that are not related parties (as defined in HKAS 24) makes it less likely that the entity, or other members of the group containing the entity, obtain benefits other than capital appreciation or investment income.

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

Typical characteristic - Ownership interests

Ownership interests are usually in the form of equity or similar interests (eg 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.

An entity with ownership interests in the form of debt that, in accordance with other applicable HKFRSs, do 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.

Reassessment

An investment entity is required to reassess its investment entity status if facts and circumstances indicate that its status has changed. The change of the status of an investment entity is accounted for prospectively from the date the change in status occurs.

When an entity loses its investment entity status it applies HKFRS 3 *Business Combinations* to subsidiaries previously measured at fair value through profit or loss. The date of the change of status is the deemed acquisition date and the fair value of the subsidiary at that date is the deemed consideration. This recognises the change in status in the same way as a business combination achieved in stages in HKFRS 3. The difference between the deemed consideration, the amount of any non-controlling interest and the acquisition date amounts of the identifiable assets acquired and liabilities assumed (measured in accordance with HKFRS 3) is recognised as goodwill or a bargain purchase.

When an entity becomes an investment entity, it ceases to consolidate its subsidiaries at the date of the change of status except for any subsidiary that it is required to continue to consolidate as noted above (eg subsidiaries that provide services that relate only to the investment entity's own investment activities). The investment entity accounts for the change in status as a deemed disposal or loss of control under HKFRS 10 *Consolidated Financial Statements* with any resulting gain or loss being recognised in profit or loss.

Disclosures

HKFRS 12 *Disclosure of Interests in Other Entities* has also been amended to require an investment entity to disclose the significant judgements and assumptions that it has made in determining that it is an investment entity. If an investment entity does not have all of the typical characteristics of an investment entity it is required to disclose the reasons for concluding that it is nevertheless an investment entity.

Other disclosures include:

- The fact that they account for their investment in a subsidiary at fair value through profit or loss and not by consolidation
- The fact and reason when an entity becomes, or ceases to be, an investment entity
- The effect of the change of status on the financial statements when it becomes an investment entity (total fair value, total gain or loss and identification of the item in which recognised)
- Specified information about unconsolidated subsidiaries (eg name, place of business, percentage held). An investment entity that is a parent of another investment entity should provide this information about unconsolidated subsidiaries that are controlled by its investment entity subsidiary

- The nature and extent of significant restrictions on the ability of an unconsolidated subsidiary to transfer funds to the investment entity (eg cash dividends or repayment of loans or advances)
- Any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support
- Details of financial or other support provided to unconsolidated subsidiaries by the investment entity or its subsidiaries without having a contractual obligation to do so
- The terms of contractual arrangements that could require the entity (or its unconsolidated subsidiaries) to provide financial support to an unconsolidated, controlled, structured entity, including circumstances that could expose the reporting entity to a loss
- Details of financial or other support provided to an unconsolidated, structured entity that resulted in the investment entity controlling the structured entity, where the financial or other support was provided by the investment entity (or its unconsolidated subsidiaries) without having a contractual obligation to do.

Transitional provisions

The amendments are mandatory for annual periods beginning on or after 1 January 2014. They are to be applied retrospectively but with some transitional provisions. The ED proposed that the amendments should be applied prospectively.

An entity is required to assess whether it is an investment entity on the basis of the facts and circumstances that exist at the date of initial application (the beginning of the annual reporting period for which the amendments are applied for the first time).

An investment entity is required to retrospectively adjust the annual period that immediately precedes the date of initial application and equity at the beginning of that immediately preceding period for any difference between:

- The previous carrying amount of the subsidiary
- The fair value of the investment entity's investment in the subsidiary.

Any amounts of fair value adjustments previously recognised in other comprehensive income should be transferred to retained earnings at the beginning of the immediately preceding period.

For periods before the date that HKFRS 13 *Fair Value Measurement* is adopted, an investment entity should use the fair value amounts that were previously reported to investors or to management. Provided that those amounts represent the amount for which the investment could have been exchanged between knowledgeable, willing parties in an arm's length transaction at the date of the valuation.

If measuring an investment in a subsidiary at fair value as described above is impracticable (ie when the entity cannot apply it after making every reasonable effort to do so – HKAS 8), an investment entity must determine the fair value of its subsidiary at the beginning of the earliest period for which it is practicable, which may be the current period. In the latter case, the adjustment to equity is recognised at the beginning of the current period.

An investment entity is not required to make adjustments to the previous accounting for subsidiaries that it disposed of, or has lost control of before the date of initial application.

Illustrative Examples – Replicated from *Investment Entities – Amendments to HKFRS 10, HKFRS 12 and HKAS 27*

Example 1

An entity, Limited Partnership, is formed in 20X1 as a limited partnership with a 10-year life. The offering memorandum states that Limited Partnership's purpose is to invest in entities with rapid growth potential, with the objective of realising capital appreciation over their life. Entity GP (the general partner of Limited Partnership) provides 1 per cent of the capital to Limited Partnership and has the responsibility of identifying suitable investments for the partnership. Approximately 75 limited partners, who are unrelated to Entity GP, provide 99 per cent of the capital to the partnership.

Limited Partnership begins its investment activities in 20X1. However, no suitable investments are identified by the end of 20X1. In 20X2 Limited Partnership acquires a controlling interest in one entity, ABC Corporation. Limited Partnership is unable to close another investment transaction until 20X3, at which time it acquires equity interests in five additional operating companies. Other than acquiring these equity interests, Limited Partnership conducts no other activities. Limited Partnership measures and evaluates its investments on a fair value basis and this information is provided to Entity GP and the external investors.

Limited Partnership has plans to dispose of its interests in each of its investees during the 10-year stated life of the partnership. Such disposals include the outright sale for cash, the distribution of marketable equity securities to investors following the successful public offering of the investees' securities and the disposal of investments to the public or other unrelated entities.

Conclusion

From the information provided, Limited Partnership meets the definition of an investment entity from formation in 20X1 to 31 December 20X3 because the following conditions exist:

- (a) Limited Partnership has obtained funds from the limited partners and is providing those limited partners with investment management services;
- (b) Limited Partnership's only activity is acquiring equity interests in operating companies with the purpose of realising capital appreciation over the life of the investments. Limited Partnership has identified and documented exit strategies for its investments, all of which are equity investments; and
- (c) Limited Partnership measures and evaluates its investments on a fair value basis and reports this financial information to its investors.

In addition, Limited Partnership displays the following typical characteristics of an investment entity:

- (a) Limited Partnership is funded by many investors;
- (b) its limited partners are unrelated to Limited Partnership; and
- (c) ownership in Limited Partnership is represented by units of partnership interests acquired through a capital contribution.

Limited Partnership does not hold more than one investment throughout the period. However, this is because it was still in its start-up period and had not identified suitable investment opportunities.

Example 2

High Technology Fund was formed by Technology Corporation to invest in technology start-up companies for capital appreciation. Technology Corporation holds a 70 per cent interest in High Technology Fund and controls High Technology Fund; the other 30 per cent ownership interest in High Technology Fund is owned by 10 unrelated investors. Technology Corporation holds options to acquire investments held by High Technology Fund, at their fair value, which would be exercised if the technology developed by the investees would benefit the operations of Technology Corporation. No plans for exiting the investments have been identified by High Technology Fund. High Technology Fund is managed by an investment adviser that acts as agent for the investors in High Technology Fund.

Conclusion

Even though High Technology Fund's business purpose is investing for capital appreciation and it provides investment management services to its investors, High Technology Fund is not an investment entity because of the following arrangements and circumstances:

- (a) Technology Corporation, the parent of High Technology Fund, holds options to acquire investments in investees held by High Technology Fund if the assets developed by the investees would benefit the operations of Technology Corporation. This provides a benefit in addition to capital appreciation or investment income; and
- (b) the investment plans of High Technology Fund do not include exit strategies for its investments, which are equity investments. The options held by Technology Corporation are not controlled by High Technology Fund and do not constitute an exit strategy.

Example 3

Real Estate Entity was formed to develop, own and operate retail, office and other commercial properties. Real Estate Entity typically holds its property in separate wholly-owned subsidiaries, which have no other substantial assets or liabilities other than borrowings used to finance the related investment property. Real Estate Entity and each of its subsidiaries report their investment properties at fair value in accordance with HKAS 40 *Investment Property*. Real Estate Entity does not have a set time frame for disposing of its property investments, but uses fair value to help identify the optimal time for disposal. Although fair value is one performance indicator, Real Estate Entity and its investors use other measures, including information about expected cash flows, rental revenues and expenses, to assess performance and to make investment decisions. The key management personnel of Real Estate Entity do not consider fair value information to be the primary measurement attribute to evaluate the performance of its investments but rather a part of a group of equally relevant key performance indicators.

Real Estate Entity undertakes extensive property and asset management activities, including property maintenance, capital expenditure, redevelopment, marketing and tenant selection, some of which it outsources to third parties. This includes the selection of properties for refurbishment, development and the negotiation with suppliers for the design and construction work to be done to develop such properties. This development activity forms a separate substantial part of Real Estate Entity's business activities.

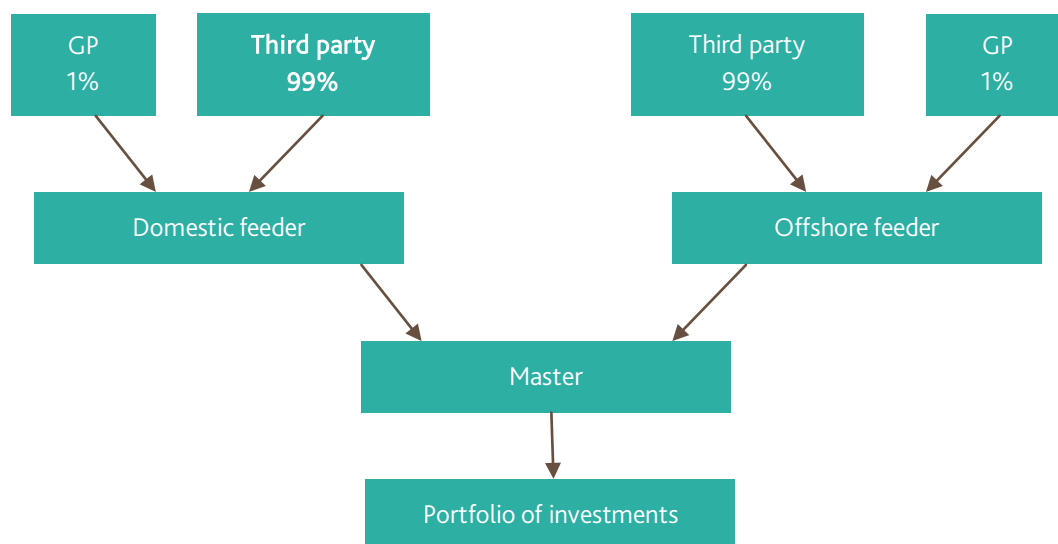
Conclusion

Real Estate Entity does not meet the definition of an investment entity because:

- (a) Real Estate Entity 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;
- (b) the investment plans of Real Estate Entity do not include specified exit strategies for its investments. As a result, Real Estate Entity plans to hold those property investments indefinitely; and
- (c) although Real Estate Entity reports its investment properties at fair value in accordance with HKAS 40, fair value is not the primary measurement attribute used by management to evaluate the performance of its investments. Other performance indicators are used to evaluate performance and make investment decisions.

Example 4

An entity, Master Fund, is formed in 20X1 with a 10-year life. The equity of Master Fund is held by two related feeder funds. The feeder funds are established in connection with each other to meet legal, regulatory, tax or similar requirements. The feeder funds are capitalised with a 1 per cent investment from the general partner and 99 per cent from equity investors that are unrelated to the general partner (with no party holding a controlling financial interest).



The purpose of Master Fund is to hold a portfolio of investments in order to generate capital appreciation and investment income (such as dividends, interest or rental income). The investment objective communicated to investors is that the sole purpose of the Master-Feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Master Fund has identified and documented exit strategies for the equity and non-financial investments that it holds. Master Fund holds a portfolio of short-term and medium-term debt investments, some of which will be held until maturity and some of which will be traded but Master Fund has not specifically identified which investments will be held and which will be traded. Master Fund measures and evaluates substantially all of its investments, including its debt investments, on a fair value basis. In addition, investors receive periodic financial information, on a fair value basis, from the feeder funds. Ownership in both Master Fund and the feeder funds is represented through units of equity.

Conclusion

Master Fund and the feeder funds each meet the definition of an investment entity. The following conditions exist:

- (a) both Master Fund and the feeder funds have obtained funds for the purpose of providing investors with investment management services;
- (b) the Master-Feeder structure's business purpose, which was communicated directly to investors of the feeder funds, is investing solely for capital appreciation and investment income and Master Fund has identified and documented potential exit strategies for its equity and non-financial investments.
- (c) although the feeder funds do not have an exit strategy for their interests in Master Fund, the feeder funds can nevertheless be considered to have an exit strategy for their investments because Master Fund was formed in connection with the feeder funds and holds investments on behalf of the feeder funds; and
- (d) the investments held by Master Fund are measured and evaluated on a fair value basis and information about the investments made by Master Fund is provided to investors on a fair value basis through the feeder funds.

Master Fund and the feeder funds were formed in connection with each other for legal, regulatory, tax or similar requirements. When considered together, they display the following typical characteristics of an investment entity:

- (a) the feeder funds indirectly hold more than one investment because Master Fund holds a portfolio of investments;
- (b) although Master Fund is wholly capitalised by the feeder funds, the feeder funds are funded by many investors who are unrelated to the feeder funds (and to the general partner); and
- (c) ownership in the feeder funds is represented by units of equity interests acquired through a capital contribution.

BDO's support and assistance on HKFRS/IFRS

For any support and assistance on HKFRS/IFRS, please talk to your usual BDO contact or email info@bdo.com.hk

Click [here](#) for more BDO publications on HKFRS/IFRS.

BDO Limited, a Hong Kong limited company, is a member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms.

BDO is the brand name for the BDO network and for each of the BDO Member Firms.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact BDO Limited to discuss these matters in the context of your particular circumstances. BDO Limited, its partners, employees and agents do not accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

© 2012 BDO Limited

www.bdo.com.hk