

IFRS news

IASB provides exemption from consolidation for ‘investment entities’

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Many funds and similar entities will be exempted from consolidating controlled investees under amendments to IFRS 10, ‘Consolidated financial statements’. Michael Gaull looks at the implications.

What’s new?

Many funds and similar entities will be exempted from consolidating controlled investees under amendments to IFRS 10, ‘Consolidated financial statements’. This is a result of the IASB issuing amendments to IFRS 10, IFRS 12, ‘Disclosure of interests in other entities’ and IAS 27, ‘Separate financial statements’, on 31 October 2012. This will particularly benefit private equity funds, as those that qualify will fair-value all of their investments, including those that are controlled.

The guidance applies to an ‘investment entity’. The amendment to IFRS 10 defines an investment entity and introduces an exception from consolidation. The amendments to IFRS 12 also introduce disclosures that an investment entity needs to make.

The amendments apply for annual periods beginning on or after 1 January 2014; earlier application is permitted.

The key features are set out below.

Definition of an investment entity

You will need to make an assessment of whether your business meets the investment entity definition.

An investment entity is an entity that:

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

You will also need to consider a set of typical characteristics. These, combined with the definition, are intended to allow for an appropriate balance between creating a clear scope and allowing judgement in assessing whether you are an investment entity.

The characteristics are:

- holding more than one investment;
- having more than one investor;
- having investors that are not related parties of the entity; and
- having ownership interests in the form of equity or similar interests.

The absence of one or more of these characteristics does not prevent the entity from qualifying as an investment entity.

You will not be disqualified from being an investment entity where you carry out any of the following activities:

- provision of investment-related services to third parties and to your investors, even when substantial; and
- providing management services and financial support to your investees, but only when these do not represent separate substantial business activity and are carried out with the objective of maximising the investment return from your investees.

Exception from consolidation and measurement of investees

You are required to account for your subsidiaries at fair value through profit or loss in accordance with IFRS 9, 'Financial instruments' (or IAS 39, 'Financial instruments: recognition and measurement', where applicable), where you qualify as an investment entity. The only exception is for subsidiaries that provide services to you that are related to your investment activities, which are consolidated.

Accounting by a non-investment entity parent for the controlled investments of an investment entity subsidiary

You may be an investment entity but your parent is not. For example, your investment entity fund is controlled by an insurance company. Your noninvestment entity parent is required to consolidate all entities it controls including those controlled through an investment entity. The insurance group will have to consolidate the subsidiaries of your fund in the insurance group's financial statements, even though in your fund's own financial statements you will fair value your subsidiaries. Therefore, what is known as the fair value 'roll-up' is not permitted to a non-investment parent entity.

Disclosure

Required disclosures, where you qualify as an investment entity, include the following:

- significant judgements and assumptions made in determining that you have met the definition of an investment entity;
- reasons for concluding that you are an investment entity even though you don't have one or more of the typical characteristics;
- information on each unconsolidated subsidiary (name, country of incorporation, proportion of ownership interest held);
- restrictions on unconsolidated subsidiaries transferring funds to the investment entity;
- financial or other support provided to unconsolidated subsidiaries during the year, where there wasn't any contractual obligation to do so; and
- information about any 'structured entities' you control (for example, any contractual arrangements to provide any financial or other support).

Am I affected?

You will be affected if you are a fund or a similar entity. Some may qualify as investment entities, and some may not.

What do I need to do?

You should look closely at the guidance to determine whether or not you are an investment entity. If you are, for example, a property fund that actively develops properties, you are unlikely to qualify, as your objective is not solely capital appreciation or investment income. On the other hand, if you are a limited life fund set up to buy and sell or list a range of infrastructure subsidiaries, you might qualify as an investment entity.

You should start collating comparative information where you qualify as an investment entity, as the change in accounting has to be applied retrospectively in most cases.

Viewpoint: Are you truly happy with your accounting framework?



IFRS has plenty of critics around the world. We know that the standards aren't perfect, but much of the criticism is unfair and ill-informed. Leader of PwC's Accounting Consulting Services in the UK, Peter Holgate, gives a personal view of the criticisms of IFRS.

Hands up who is truly happy with the accounting framework under which they work. My guess is that you don't entirely agree with it. Most of it's fine, of course, but there are just a couple of things that you would like to change. Business combination accounting used to make sense, but we now have too many gains and losses that are hard to interpret. As for deferred tax, can we please all agree, once and for all, that the best method of accounting for it is not to account for it? And there's too much disclosure ... and yet not enough of the right kind.

So it's not perfect. Welcome to the real world. Accounting cannot, and never will, exactly capture and faithfully report all economic circumstances and events in a way that provides a perfect insight into a company. The real questions seem to be: (i) are the accounting rules reasonably suitable, (ii) are they in good hands, and (iii) are they going in a good direction?

Against this benchmark, some of the criticisms of IFRS, to my mind, miss the point. We have heard in recent months that: (a) IFRS does not give a true and fair view; (b) IFRS conflicts with certain national or regional laws; and (c) IFRS was the cause of the financial crisis. These accusations are not merely exaggerations; they are plain wrong. Let's take these points in turn.

True and fair view

IFRS will generally give a true and fair view, partly because of the EU criteria that they have to meet before they can be applied in the EU. And for those who would suggest that IFRS had any part to play in causing the

financial crisis, it was the smallest of walk-on parts, probably in the interval in fact. It may be that the incurred loss approach of IAS 39 has tended to recognise losses later than perhaps they should have been recognised; but the IASB is now working on an improved approach to loss recognition based on expected losses.

Safe hands and right direction

IFRS is global and is trying to deal with the issues of today. It is a coherent system of standards and it works reasonably well, though not perfectly. It is in good hands. The structure of the IFRS Foundation, its trustees and its monitoring board seeks to keep the board independent and accountable. Its system of due process is impressive (indeed, arguably, excessive and a burden on progress). But overall it is in good hands. And it is making progress on trying to improve a number of existing standards and develop some new ones to fill the gaps. So it answers my three questions (above) pretty well.

The simple fact is that, if you want a global framework, you have to sign up to the one that you think is the best contender, in the safe knowledge that there are aspects of it that you won't like. No national system of accounting (including US GAAP) is suitable for international adoption. IFRS is the best contender. I'm not truly happy with IFRS; but I support it because that it's the best one we've got.

This article is adapted from the original, 'Are you truly happy with your accounting framework?', published in the ICAEW magazine, 'economia', in August 2012.

Cannon Street Press

Revenue project: Boards decide on contract modifications and measures of progress

The IASB and FASB ('the boards') continued to discuss their joint project on revenue recognition. They reached tentative decisions on contract modifications and measures of progress towards satisfying a performance obligation.

Contract modifications

The boards decided to clarify the guidance proposed in the 2011 exposure draft for contract modifications as follows:

- Revenue from contract modifications that have not been approved should not be recognised until the modification is approved.
- Contract modifications that only affect the transaction price should be accounted for prospectively or on a cumulative catch-up basis depending on whether the remaining performance obligations are distinct.

Measures of progress towards satisfaction of a performance obligation

Revenue is recognised for a performance obligation satisfied over time as the entity

progresses toward satisfying that performance obligation. The boards considered whether a practical expedient should be introduced for certain manufacturing operations that meet the requirements to be accounted for as performance obligations satisfied over time but made no changes to the proposed guidance. They confirmed that an entity should select a method that depicts the transfer of control to the customer. This could result in a change in the timing of revenue recognition from today for certain entities which use units of delivery as measure of progress.

Next steps

They will continue their redeliberations over the next few months with a number of key issues to remaining to be discussed including collectibility, the constraint on recognising revenue from variable consideration, licences, allocation of transaction price, disclosures and transition. The boards' timeline indicates issuance of a final standard in the first half of 2013 with an effective date no earlier than 1 January 2015.

IASB decides on targeted re-exposure of insurance contracts proposal

Although the deliberations on the insurance project are not complete, the IASB has decided to re-expose the proposals but only on a limited range of questions. The targeted questions in the new exposure draft will relate to proposed requirements for:

(a) treatment of participating contracts;

- (b) presentation of premiums in the statement of comprehensive income;
- (c) treatment of the unearned profit in an insurance contract;
- (d) presenting, in other comprehensive income, the effect of changes in the discount rate used to measure the insurance contract liability; and
- (e) the approach to transition.

IFRS Foundation staff responds to SEC work plan

The staff of the IFRS Foundation (the parent organisation of the IASB and the IFRS IC) has published a response to the final report on the SEC's IFRS 'work plan' (the SEC report).

The SEC issued their final report on the IFRS 'Work Plan' in July 2012 (see [Straight away 74, 'SEC reports on IFRS'](#)). The report completed the work programme that the SEC Commissioners had requested the staff to undertake to enable a US decision on whether to adopt IFRS for domestic companies.

The response analyses the main issues identified by the SEC and sets out the perspectives of the Foundation staff. It seems to draw different conclusions from those reached in the SEC report in several areas. It also sets out information that they indicate might not have been fully considered or given appropriate weight by the SEC staff.

The Foundation staff's response analyses the key areas of comment in the SEC staff report, including:

- the governance, funding and due process of the IASB and the IFRS Foundation;
- assessing IFRS as a set of global accounting standards;
- how IFRS might be implemented in the US; and
- the practical experience of adoption in other countries, including the cost of transition for preparers and investor education issues.

The SEC staff report identified potential improvements in the IFRS interpretative process, the enforcement and co-ordination activities of regulators and better working with national standard setters. The Foundation response sets out actions in most of these areas that are in progress in response to reviews undertaken earlier by the Foundation Trustees and Monitoring Board.

A final section of the response considers the benefits of IFRS, including how the US might benefit from adoption.

The Foundation staff response does not reach any formal conclusions and is not a due process document of the IFRS Foundation. It provides interesting insight into the perspectives of the Foundation on the accomplishments and challenges of developing and maintaining a comprehensive body of accounting standards suitable for global use.

The report will have no immediate direct impact. It seeks the continued involvement of the US in the work of the IFRS Foundation, but there are several observations around the funding model and the number of seats on the IASB and IFRS IC currently occupied by the US.

The discussions and perspectives of the Foundation staff on endorsement mechanisms, transition, the cost and benefits of IFRS adoption will be of most interest to any country that is considering adoption of IFRS.

Know your IFRS 'ABC': A is for 'associates'



Welcome to our new series of questions and answers on typical IFRS implementation issues. Each month, we will look at a different financial reporting topic, by alphabet, and give you practical guidance on common challenges that arise in applying the standards. Derek Carmichael from PwC's Accounting Consulting Services Central Team kicks the series off.

This month, we start with *A for 'associates'*.

An associate is an entity over which an investor has 'significant influence'. An entity applies equity accounting to its investments in associates in its consolidated financial statements except where a specific exemption applies.

Board representation and significant influence

The existence of significant influence can be evidenced by representation on the board of directors and participation in policy-making processes, according to IAS 28. Does an investor with a board representative in an entity therefore automatically have significant influence?

Background

X Ltd has recently invested in a manufacturing entity, A Ltd. They have purchased newly-issued share capital, which will provide them with an 8% holding in the entity. As part of the acquisition, X Ltd obtained the right to appoint one director to the board. The board is the ultimate decision-making body that determines the financial and operating policies of X Ltd. The board has 10 directors in total.

The shareholder analysis of A Ltd shows the following shareholders that have 5% interest or more.

	Shareholding	Board representation
W Ltd	40%	4
B Ltd	30%	3
X Ltd	8%	1
Individual C (Managing Director of A Ltd)	6%	1
Individual D (Finance Director of A Ltd)	6%	1

Board decisions are passed by a 70% majority of voting directors.

Question

Is a 10% shareholding and representation of one director on the board sufficient to provide X Ltd with significant influence?

Analysis

X Ltd has one director on the board of directors, which consists of 10 members. The board is dominated by two investors who can make decisions without the agreement of

other board members. The standard mentions board representation as an indicator of significant influence but does not provide further guidance on how to evaluate the representation in the context of the size of the board, voting patterns and the like. Management of X Ltd considers that a reasonable reference for significant influence is the proportion of board seats.

X Ltd only has 10% of the board seats and believes this is not sufficient significant influence, given the presence of the two major investors and two members of management on the board. Although X Ltd participates in the policy-making processes and decisions, it cannot significantly influence those decisions.

X Ltd, in this scenario, does not have significant influence over Y Ltd.

Key message

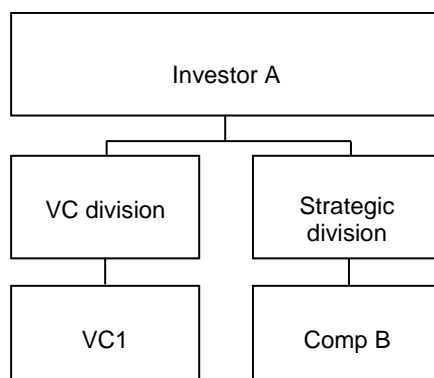
Having a representative on the board of directors is an indicator of significant influence. It is not an automatic confirmation. Relevant facts and circumstances need to be considered.

Change in venture capital intention

IAS 28 provides an exemption from applying the equity method of accounting if an investment in an associate is held by or indirectly through an entity that is a venture capital organisation (VCO). An associate that held by an entity that qualifies for the VCO exemption is accounted for a fair value through profit or loss under IAS 39. Can an investor that has significant influence and claims the exemption, subsequently account for an associate using the equity method because A has changed its intentions with regard to the associate?

Background

Investor A has two divisions: a venture capital division and a strategic division. Through its venture capital division, it exercises significant influence over VC 1, a start-up retail business.



Investor A has claimed the venture capital exemption for its VC division and accounts for VC 1 and other associate level holdings of the VC division at fair value through profit or loss, in accordance with IAS 39. Entities within the strategic division over which A has significant influence are accounted for using the equity method.

Investor A changes its plans with respect to VC 1 and no longer intends to exit from the investment in the foreseeable future. It has transferred VC 1 to its strategic division.

Question

Should Investor A cease claiming the VCO exemption for its investment in VC 1 following the change in intention and transfer to the strategic division?

Analysis

IAS 28, 'Investments in associates', does not include specific guidance on how to account for an associate to which the VCO exemption had previously been applied. However, it does not prohibit changes in classification, nor does it require an irrevocable designation at initial recognition or any other point. Therefore, a change in intention of A and the transfer to the strategic division are sufficient to support a change in accounting from fair value to equity method.

Key message

An investor can have associates that accounts for using both the equity method and at fair value through profit or loss under IAS 39, in specific circumstances. The investor can change its method of accounting for an associate but there should be an express change in the plans for the associate. The investment in the associate should no longer be managed by the portion of the entity that is claiming the VCO exemption.

Last word from the editor

After 10 years of editing *IFRS news*, I am leaving PwC's Accounting Consulting Services group (although not PwC) and so wanted to take this opportunity – my first and last – to address you directly and reflect on the last decade of our newsletter.

Our first edition was published in September 2002 and looked at, among other things, the European Commission's decision to require listed companies to adopt IFRS by 2005. Remember those fun times? We got there in the end. We subsequently published features from other countries transitioning to IFRS and found the challenges quite similar across the world.

We have published a number of other series over the last few years, including our popular 'beginners' guides' (running in most editions from July/August 2008 to February 2010), interviews with

leading figures in the IFRS world, industry-specific features, IFRS quizzes, crosswords, topical and seasonal poems and Haikus, and the occasional cartoon. It's been an eclectic mix, and a lot of fun.

But the mission for *IFRS news* to provide readers with updates on the latest developments and their implications for business continues. From next month, Andrea Allocco will take over the editorship. Andrea, based in the Accounting Consulting Services Central Team, is already a frequent contributor to the newsletter. I wish her luck in the new role. Finally, many thanks to Mary Dolson, who has been a great support and will continue to oversee *IFRS news* – and contribute the occasional verse!

Joanna Malvern

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