Tech Q&A

The Institute issued an exception to the consolidation requirements in HKFRS 10 *Consolidated Financial Statements,* which is applicable to a particular class of business that qualifies as an "investment entity." Could you provide details of this exception?

Under HKFRS 10 *Consolidated Financial Statements*, reporting entities are required to consolidate all investees that they control (i.e. all subsidiaries). During the development of that standard, preparers and users of financial statements suggested the introduction of an exception for entities for which the only business purpose is to make investments for capital appreciation, investment income, or both, and which evaluate the performance of those investments on a fair value basis. Such entities are commonly referred to as investment entities.

In response to this, *Investment Entities* (amendments to HKFRS 10, HKFRS 12 *Disclosure of Interests in Other Entities* and HKAS 27 (2011) *Separate Financial Statements*) was issued in December 2012. These amendments include:

- The creation of a definition of an investment entity;
- The requirement that such entities measure investments in subsidiaries at fair value through profit or loss in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement* (or HKFRS 9 *Financial Instruments*) instead of consolidating them;
- New disclosure requirements for investment entities; and
- Requirements for an investment entity's separate financial statements.

The new requirements contained in the amendments are principally concerned with establishing whether an entity qualifies as an investment entity. Paragraph 27 of HKFRS 10 states that an investment entity is one that:

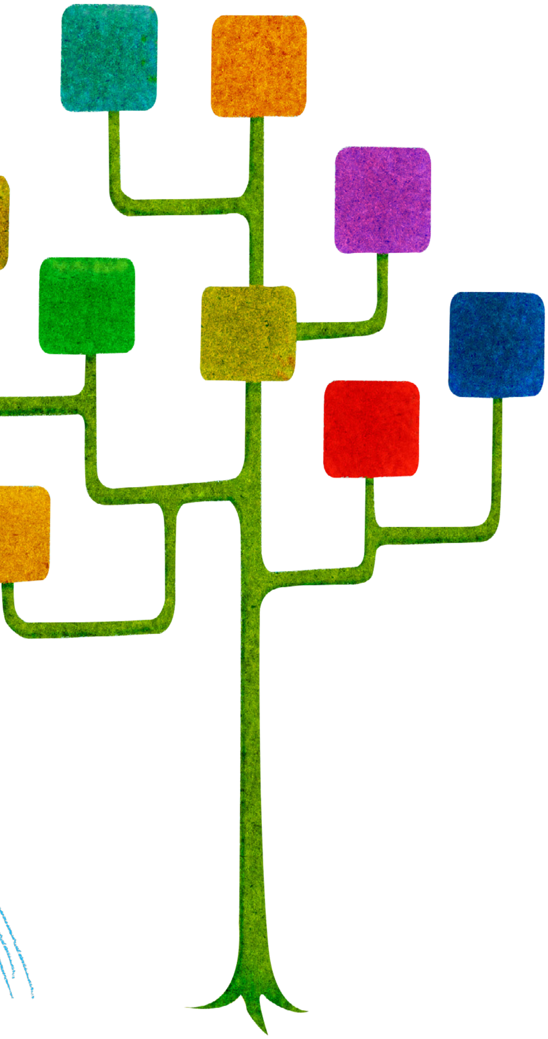
a) Obtains funds from one or more investors for the purpose of providing those investors with investment management services;
b) Commits to its investors that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both; and
c) Measures and evaluates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

The application guidance accompanying HKFRS 10 requires an entity to consider all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. In this connection, the application guidance describes the elements of the definition in more detail as follows:

The definition of an investment entity requires that the purpose of the entity is to invest solely for capital appreciation, investment income (such as dividends, interest or rental income) or both. An investment entity may also participate in the following investment-related activities, either directly or through a subsidiary, if these activities are undertaken with a view to maximizing the investment return (capital appreciation and/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:

a) Providing management services and strategic advice to an investee; and
b) Providing financial support to an investee, such as a loan, capital commitment or guarantee.

One feature that differentiates an investment entity from other entities is that an investment entity does not plan to hold its investments indefinitely; it holds them for a limited period. Because equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity shall have an exit strategy documenting how the entity plans to realize capital appreciation from substantially



all of its equity investments and non-financial asset investments.

If an entity or another member of the group containing the entity (i.e. the group that is controlled by the investment entity's ultimate parent) obtains, or has the objective of obtaining, other benefits from the entity's investments that are not available to other parties (unrelated to the investee), then the entity is not considered to be investing solely for capital appreciation, investment income or both, and thus would not qualify as being an investment entity.

An essential element of the definition of an investment entity is that it measures and evaluates the performance of substantially all of its investments on a fair value basis, because using fair value is more relevant 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 and measures substantially all of its investments at fair value in its financial statements whenever fair value is required or permitted in accordance with HKFRSs; and reports fair value information internally to the entity's key management personnel, who use fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

In order to meet this requirement, an investment entity would:

a) Elect to account for any investment property using the fair value model in HKAS 40 *Investment Property*;
b) Elect the exemption from applying the equity method in HKAS 28 (2011) *Investment in Associates and Joint Ventures* for its investments in associates and joint ventures; and
c) Measure its financial assets at fair value using the requirements in HKAS 39/HKFRS 9.

In assessing whether an entity meets the definition of an investment entity as described in paragraph 27, the entity must consider whether it has the following typical characteristics:

a) It has more than one investment – an investment entity typically holds several investments to diversify its risk and maximize it returns;
b) It has more than one investor – 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;
c) It has investors that are not related parties of the entity; and
d) It has ownership interests in the form of equity or similar interests.

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. However, it has to provide additional disclosure required by HKFRS 12 in stating its reasons for concluding that it is nonetheless an investment entity.

In addition to the above-mentioned disclosures, HKFRS 12 has also been amended to require disclosure of information about significant judgments and assumptions the investment entity has made in determining that it meets the definition of an investment entity; information on each unconsolidated subsidiary; the nature and extent of any significant restrictions of unconsolidated subsidiaries to transfer funds to the investment entity; and financial or other support provided to unconsolidated subsidiaries during the year where there wasn't a contractual obligation to do so. Disclosures are also required for any structured entity that it controls.

The amendments are effective from 1 January 2014, with early adoption permitted. This is one year later than the effective date of HKFRS 10. However, the amendments permit early adoption in order to allow investment entities to apply the *Investment Entities* amendments at the same time they first apply the rest of HKFRS 10.

Send your questions and comments to *commentletters@hkicpa.org.hk*. The standard setting team will answer these questions in accordance with its policy, posted on the Institute's website.