IFRS Accounting

Staff paper

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IASB® meeting

Date	**December 2023**
Project	**Second Comprehensive Review of the *IFRS for SMEs*® Accounting Standard**
Topic	**Investment entities**
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Purpose of the paper

1. The purpose of this paper is for the International Accounting Standards Board (IASB) to:
   (a) consider feedback from comment letters on investment entities—a topic that the IASB considered but for which amendments were not proposed in the Exposure Draft *Third edition of the* IFRS for SMEs *Accounting Standard* (Exposure Draft); and
   (b) decide whether to amend Section 9 *Consolidated and Separate Financial Statements* of the *IFRS for SMEs* Accounting Standard (the Standard).

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the Standard.

Staff recommendation

3. The staff recommend the IASB does not amend Section 9 of the *IFRS for SMEs* Accounting Standard to include requirements for investment entities.

Structure of this paper

4. This paper is structured as follows:

   (a) background (paragraphs 5–13);

   (b) feedback from comment letters (paragraph 14–15);

   (c) staff analysis (paragraphs 16–47);

   (d) staff recommendation and question for the IASB (paragraph 48); and

   (e) Appendix—extract from the Basis for Conclusions on the Exposure Draft.

Background

Current requirements

5. IFRS 10 *Consolidated Financial Statements* requires an investment entity to measure an investment in a subsidiary at fair value through profit or loss. The *IFRS for SMEs* Accounting Standard has no equivalent requirement.

Developing the 2020 Request for Information

6. In January 2020, the IASB published Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard* (2020 Request for Information) as a first step in its second comprehensive review of the Standard.

7. Based on the definition of an 'investment entity' in IFRS 10, the IASB considered that few entities eligible to apply the Standard will be investment entities.

8. In developing the 2020 Request for Information, the IASB took into consideration the feedback from the SMEIG members who were divided on whether Section 9 of the Standard should include requirements for investment entities.[1]

[1] See Agenda paper 30B IFRS 10 *Consolidated Financial Statements* of the July 2019 IASB meeting and IASB update.

9. Some SMEIG members said the Standard should include the requirements for investment entities. One of those SMEIG members said these requirements will be a cost relief for SMEs. Some SMEIG members said the Standard should not include the requirements for investment entities and provided the following views:

    (a) few SMEs are investment entities;

    (b) investment entities have public accountability and cannot apply the Standard;

    (c) investment entities applying the Standard may not have their investment strategies sufficiently documented to demonstrate that they meet all the requirements for classification as an investment entity; and

    (d) alignment would place an undue burden on investment entities to measure the fair value of non-listed companies. Consequently, investment entities applying the Standard should be relieved from measuring the fair value of investments.

Feedback from the 2020 Request for Information

10. The 2020 Request for Information asked for views on not introducing the requirement that investment entities measure investments in subsidiaries at fair value through profit or loss.

11. Some respondents agreed with the IASB's view not to introduce the requirement that investment entities measure investments in subsidiaries at fair value through profit or loss because few SMEs are likely to qualify as investment entities and the requirement to determine fair value may be too complex for SMEs. However, a few respondents were of the view that the requirement should be introduced as it will be relevant to some entities applying the Standard and adds to faithful representation.

12. After considering the feedback from the 2020 Request for Information, SMEIG members still had mixed views on not introducing the requirement that an investment

entity measures its investment in subsidiaries at fair value through profit or loss.[2] The SMEIG members provided the following views:

(a) some private equity entities that are not publicly accountable and some high-net-worth-individuals apply the Standard and would prefer to measure investments in subsidiaries at fair value;

(b) many SMEs would not meet the definition of an investment entity and so the accounting requirements for investment entities would not be relevant; and

(c) not introducing the investment entity requirements would maintain the simplicity of the Standard.

Proposals in the Exposure Draft

13. The IASB, based on its initial view and the feedback on the 2020 Request for Information (and further advice from the SMEIG), did not propose as part of the Exposure Draft to introduce the requirement for an investment entity to measure its investments in subsidiaries at fair value. The IASB's reasoning is explained in paragraphs BC59–BC60 of the Basis of Conclusions on the Exposure Draft (see Appendix A of this paper).

Feedback from comment letters

14. The IASB did not ask a question on investment entities in the Invitation to Comment of the Exposure Draft. However, when responding to Question 3 of the Invitation to Comment on the Exposure Draft, a few respondents provided views on the IASB's decision not to introduce requirements for investment entities in the Exposure Draft.

15. The respondents disagreed with not introducing requirements for investment entities. They said that there are investment entities in the scope of the Standard and thereby

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[2] See February 2021 Report on the SMEIG meeting.

disagreed with the IASB's view on relevance to SMEs. Some of these respondents suggested that the IASB consider introducing an accounting policy option that permits investment entities to measure their investments in subsidiaries at fair value through profit or loss.

Staff analysis

16. The staff analysis is set out as follows:

    (a) application of the alignment approach (paragraphs 17–19);

    (b) assessment of relevance to SMEs (paragraphs 20–30);

    (c) assessment of simplicity (paragraphs 31–41); and

    (d) faithful representation and cost-benefits (paragraphs 42–47).

Application of the alignment approach

17. The IASB's alignment approach treats alignment with full IFRS Accounting Standards as the starting point for developing the *IFRS for SMEs* Accounting Standard, and applies the principles of relevance to SMEs, simplicity and faithful representation, including the assessment of costs and benefits, in determining whether and how that alignment should take place. The IASB applies its alignment approach to each new or revised IFRS Accounting Standard within the scope of the review.

18. The IASB did not propose to include the requirements for investment entities in the Exposure Draft, as in its view the requirements did not meet the principle of relevance to SMEs. However, a few respondents to the Exposure Draft have said the IASB should include these requirements because there could be SMEs that are investment entities.

19. The staff have assessed the feedback from comment letters using the alignment approach to assist the IASB in deciding whether to amend Section 9 of the Standard to include requirements for investment entities.

Assessment of relevance to SMEs

20. The IASB determines relevance to SMEs by assessing whether the problem addressed by a new requirement in full IFRS Accounting Standards (in the scope of the review) would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Accounting Standard.[3]

21. At its December 2021 meeting, IASB decided that investment entities did not meet the principle of relevance for SMEs that because of the scope of the Standard, few entities would qualify as investment entities. That is, entities that would be affected would be those that:

    (a) meet the definition of an SME;

    (b) meet the definition of an investment entity; and

    (c) hold controlling interests in an investee.

22. The staff note that the IASB amended IFRS 10 to require investment entities to measure investments in subsidiaries at fair value, following a long-standing request from the investment industry. Respondents to ED 10 *Consolidated Financial Statements* questioned the usefulness of financial statements in which an investment entity consolidates the investees that it controls. They provided the following reasons: [4]

[3] Paragraph BC30 of the Basis of Conclusions on the Exposure Draft.

[4] Paragraph BC217–BC219 of the Basis of Conclusions on IFRS 10 *Consolidated Financial Statements*.

(a) Some national accounting requirements, including US GAAP, have provided industry-specific guidance that requires investment entities to measure all their investments, including those that they control, at fair value.

(b) Users of the financial statements of the investment entities said that fair value of the investments provides them with the most useful information.

(c) Consolidated financial statements of an investment entity may hinder users' ability to assess an investment entity's financial position and results, because it emphasises the financial position, operations and cash flows of the investee, rather than those of the investment entity.

(d) Often, an investment entity holds non-controlling interests in some entities that are reported at fair value, as well as controlling interests in other entities that are consolidated in accordance with the principles in IFRS Accounting Standards. Reporting investments on more than one basis hinders comparability within the financial statements, because all investments are held by an investment entity for a similar purpose—returns from capital appreciation, investment income or both. In addition, some of the items consolidated may be measured at historical cost, which distorts the performance assessment of the investment entity and does not reflect the way in which the business of the entity is managed.

(e) When an investment entity consolidates entities that it controls, it is not required to provide the disclosures related to fair value measurements that would be required if the subsidiaries were measured at fair value. For example, IFRS 7 *Financial Instruments: Disclosures* relates only to recognised financial assets and liabilities. Information about fair value and the methodology and inputs used for determining fair value is vital for users to make investment decisions about investment entities.

23. In assessing the relevance of investment entities, the staff have assessed the definition of SMEs and investment entities. SMEs are entities that do not have public

accountability and publish general purpose financial statements for external users. Paragraph 1.3 of the Standard states that an entity has public accountability if:

(a) its debt or equity instruments are traded in a public market or is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or

(b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (most banks, credit unitions, insurance companies, securities brokers/dealers, mutual funds and investment banks would meet this second criterion).

24. Paragraph 27 of IFRS 10 defines an investment entity as 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.

25. Furthermore, paragraph 28 of IFRS 10 states that in assessing whether an entity meets the definition of an investment entity, it shall consider the following typical characteristics of an investment entity:

(a) it has more than one investment;

(b) it has investors that are not related parties of the entity; and

(c) it has ownership interests in the form of equity or similar interests.

26. The typical characteristics of an investment entity include that it has more than one investor and it has investors that are not related parties of the entity. This means the entity holds assets for outside investors, however this does not necessarily mean those

investors constitute a broad group of outsiders. For example, an entity that holds assets for a few high-net-worth individuals or a single high-net-worth-individual that manages its own investments could meet the definition of an investment entity.

27. An investment entity commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income or both. This means the investment entity holds assets in a fiduciary capacity as one of its primary businesses (that is, the holding of assets is not incidental to its primary business).

28. To meet the definition of an investment entity, an entity measures and evaluates the performance of substantially all of its investments on a fair value basis. The staff think it would be complex for SMEs to measure and evaluate performance of investments on a fair value basis applying proposed new Section 12 *Fair Value Measurement* in the Exposure Draft. As a result, only a few SMEs would be able to measure and evaluate the performance of investments on a fair value basis and hence would meet the criteria in paragraph 24(c) of this paper.

29. Paragraph BC297 of the Basis of Conclusions on IFRS 10 explains that although the requirement for an investment entity to measure its investment in a subsidiary at fair value through profit or loss would be important to the investment entities affected, the changes are only expected to affect a narrow range of entities. Only those entities that meet the definition of an investment entity and hold controlling interests in other entities will be affected by these changes. Furthermore, entities that are most likely to be affected include private equity funds, venture capital funds, master-feeder structures, funds-of-funds structures and some pension funds and sovereign wealth funds.[5]

30. Based on the analysis in paragraphs 23–29 of this paper, the staff think there would only be a small population of SMEs that would be affected by introducing the requirement for investment entities in the Standard. Therefore, the staff continue to support the IASB's view that the relevance principle is not met.

[5] Paragraphs BC298–BC300 of the Basis of Conclusions on IFRS 10.

Assessment of simplicity

31. Applying the principle of simplicity involves looking at the requirements in full IFRS Accounting Standards that have met the relevance principle and then assessing what simplifications are appropriate for SMEs. Although we continue to support the IASB's views on relevance we have considered possible simplifications.

32. Adding the requirements for investment entities may be perceived as adding complexity to the Standard. However, arguably that complexity is limited because:

    (a) the requirements would be industry specific, and as a result the requirements will not apply to most SMEs (which are not investment entities); and

    (b) the SMEs that are investment entities should have the information to apply the requirements.

33. The staff note that FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (FRS 102) includes a requirement for a subsidiary that is held as part of an investment portfolio to be measured at fair value with changes in fair value recognised in profit or loss.[6] The Financial Reporting Council noted that without a similar exemption (as in IFRS 10), investment entities eligible to apply FRS 102 would need to elect to apply UK adopted IFRS Standards or EU-adopted IFRS Standards in order to apply the investment entity requirements. This was not considered to be a logical or meaningful outcome and therefore a solution was sought.[7] The staff notes that the scope of FRS 102 is wider than the scope of the Standard and so more investment entities could apply FRS 102.

Definition of investment entity

34. As explained in paragraphs 23–28 of this paper an SME would need to meet the definition of an investment entity. Respondents to the Post-implementation Review of

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[6] Paragraph 9.9C of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland.*

[7] Paragraph B.9.6 of the Basis of Conclusions on FRS 102.

IFRS 10, said that in some situations it can be challenging to apply the definition of an investment entity.

35. The IASB could consider simplifying the definition of an investment entity, however, the IASB would need to conduct outreach to introduce simplifications to the definition of an investment entity as they have not been exposed for comment as part of the Exposure Draft.

Fair value information

36. As discussed in paragraph 24 of this paper, to meet the definition of an investment entity, an entity measures and evaluates the performance of substantially all of its investments on a fair value basis. The staff think there are two views on obtaining or measuring the fair value of substantially all investments (especially holdings in non-quoted companies):

(a) the SMEs that meet the definition of an investment entity would have the information to apply the requirements (see paragraph 32 of this paper).

(b) would be too complex for many SMEs (especially those with holdings in non-quoted companies) and as such only a few SMEs would be able to measure and evaluate performance of investments on a fair value basis and hence meet the definition of an investment entity (see paragraph 28 of this paper).

37. On balance the staff think that introducing the requirements for investment entities introduces complexity to the Standard, even though it could reduce ongoing cost for a small population of SMEs that are investment entities.

Introducing an accounting policy option?

38. Some respondents suggested that the IASB should introduce an accounting policy option permitting investment entities to consolidate its subsidiaries or measure its investment in subsidiaries at fair value through profit or loss.

39. The IASB aims to restrict accounting policy options in the Standard because including complex options generally increases complexity and reduces comparability. Paragraphs BC208–BC209 of the Basis for Conclusions on the Standard explain the IASB's reasons for restricting accounting policy options.

40. However, in limited cases, the IASB includes accounting policy options in the Standard applying the simplification principle. For example, the cost model, the equity method or the fair value model is permitted for accounting for investments in associates.

41. The staff note that an accounting policy option for investment entities will reduce comparability for users of financial statements of SMEs that are investment entities. The staff question whether the accounting policy option would provide useful information to the users of the financial statements.

Faithful representation and cost-benefits

42. The staff acknowledge that for the small population of SMEs that meet the definition of an investment entity, measuring a subsidiary at fair value through profit or loss could make a difference in the decision of users of the financial statements. This is because the subsidiaries would not be consolidated and the users of the SMEs' financial statements would be able to assess the investment entity's financial position and performance and obtain the fair value of all the investments, regardless of whether the investment is a non-controlling or a controlling interest.

43. However, the staff think that users of the SMEs' financial statements that are investment entities would be able to request fair value information of the entities' investments if they do not have access to this information already. This is because an investment entity meeting the definition of an SME will not be managing assets for a broad group of outsiders, and the staff think the users of the financial statements will likely be able to request information about the investment entity as opposed to users of the financial statements of investment entities that are not SMEs. For example,

high-net-worth-individuals that manage their investments will have access to information about the fair value of their investments.

44. In assessing the cost and benefits, similar to entities applying IFRS 10, SMEs that are investment entities would incur costs on initial application of the requirements. However, for IFRS 10, it was noted that the introduction of the requirements for investment entities will result in significant compliance cost savings for preparers on an ongoing basis.[8] Similarly, the staff think if the requirements are introduced into the *IFRS for SMEs* Accounting Standard, the small population of SMEs that meet the definition of an investment entity would also realise these cost savings. This is because the SMEs would not incur costs to gather information to consolidate its subsidiaries. Additionally, because an investment entity would measure and evaluate the performance of substantially all of its investments on a fair value basis, the SMEs would have the fair value information to measure its subsidiaries at fair value for the purpose of preparing its financial statements.

45. If the IASB does not introduce the requirements for investment entities, an SME that meets the definition of an investment entity would continue to incur costs to consolidate its subsidiaries. However, the SME could choose to provide additional fair value information to users of its financial statements without incurring additional costs because it will measure and evaluate the performance of substantially all of its investments on a fair value basis.

Staff conclusion

46. Although the feedback on the relevance principle is mixed, there are a few respondents that said the requirements for investment entities should be introduced as it will be relevant to SMEs and adds to faithful representation.

47. The staff think that only a few SMEs would meet the definition of an investment entity. Additionally, those SMEs that are investment entities could provide fair value

[8] Paragraph BC310 of the Basis of Conclusions on IFRS 10.

information to the users of the financial statements. Consequently, the staff think that the IASB should not amend Section 9 of the Standard to introduce the requirements for investment entities.

Staff recommendation and question for the IASB

48. The staff recommend the IASB does not amend Section 9 of the *IFRS for SMEs* Accounting Standard to include requirements for investment entities.

Question for the IASB
1. Does the IASB agree with the staff recommendation in paragraph 48 of this paper?

Appendix—extract from the Basis of Conclusions on the Exposure Draft

A1. The following extract summarises the considerations of the IASB when developing the proposals for the alignment of Section 9 of the *IFRS for SMEs* Accounting Standard with IFRS 10.

Investment entities

BC59. IFRS 10 requires an investment entity to measure an investment in a subsidiary at fair value through profit or loss and not consolidate such a subsidiary. The Standard has no equivalent requirement. In the Request for Information, the IASB explained its view that, because of the scope of the Standard, few entities would qualify as investment entities as defined in IFRS 10. That is, the IASB's assessment was that this topic did not meet the principle of relevance to SMEs. Therefore, in the Request for Information, the IASB asked for views on omitting from the Standard the requirement that an investment entity measures an investment in a subsidiary at fair value through profit or loss.

BC60. Respondents to the Request for Information agreed with the IASB's view that this topic did not meet the relevance principle because few entities eligible to apply the Standard would qualify as investment entities. However, some SMEIG members said some high-net-worth individuals hold assets in entities that would meet the definition of an 'investment entity'. These SMEIG members recommended that the IASB propose introducing the requirement that an investment entity measures investments in subsidiaries at fair value through profit or loss. However, the IASB decided against proposing requirements for investment entities in the Exposure Draft, based on its initial view and on the feedback on the Request for Information.