Ihre Ansprechpartner

Sehr geehrte Damen und Herren,

für Rückfragen zu der beigefügten Publikation „In depth“ zur Thematik „Investment entities amendment – Exception to consolidation: Impacts for real estate structures“‘ stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:

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In depth
A look at current financial reporting issues

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What's inside:

Background

Questions and answers on:

• Definition of an investment entity

• Typical characteristics of an investment entity

Investment entities amendment – Exception to consolidation

Impacts for real estate structures

At a glance

This publication contains a number of questions and answers on the application of the investment entities amendment on the exception to consolidation and assists the management of Real estate structures in assessing whether an entity or entities within those structures meet the criteria of an investment entity.

Background

In October 2012 the IASB issued the amendments to IFRS 10,'Consolidated financial statements', IFRS 12 Disclosure of interests in other entities', and IAS 27 'Separate financial statements'. The amendment is effective for annual periods beginning on or after 1 January 2014.

The amendment to IFRS 10 gives a definition of an investment entity and introduces an exemption from the requirement to consolidate particular subsidiaries; those subsidiaries are measured at fair value through profit or loss in accordance with IFRS 9 Financial instruments.

In consequence it is possible, that in the future some real estate structures will not consolidate their subsidiaries if the definition of an investment entity in IFRS 10.27 is met.

This publication contains a number of questions and answers on the application of the amendment, and assists the management of real estate structures in assessing whether an entity or entities within those structures meet the criteria of an investment entity in accordance with the amendment to IFRS 10. It is a guide with no individual question being the only determinant for assessing the application of IFRS 10.

Determining whether a real estate structure meets the definition and the application of the criteria of an investment entity has to be done on a case-by-case basis. Care should be taken in making the appropriate decision. The assessment of whether an entity meets the investment entity definition requires significant judgement for which all relevant facts and circumstances, including the purpose and design of the entity should be considered.

This publication should be read in connection with our publications 'Practical guide to IFRS 10 - Investment entities: Exception to consolidation' and 'Practical Guide - Understanding the disclosure requirements in IFRS 12'.

Key provisions

Definition of an investment entity

The management of a real estate structure will need to consider the application of IFRS 10 to their structures or groups and assess whether the relevant entity meets the definition of an investment entity. Management will need to consider all the relevant facts and circumstances, including how the entity is designed, its purpose and how it is managed to determine whether it meets the investment entity definition.

IFRS 10.27 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.

The definition encompasses the following key elements:

- Business purpose including investment-related services;
- Exit strategies;
- Earnings from investments; and
- Fair value measurement.

According to IFRS 10.28 the following typical characteristics have to be taken into consideration when assessing whether the structure meets the definition of an investment entity:

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

Services

Question 1
Does the provision of services disqualify an entity from being an investment entity?

Answer 1
It depends. Part of an entity's business purpose might be to provide investment-related services (including investment advisory services, investment management, and investment support and administrative services) either directly or through a subsidiary. These services could be provided to investors and/or third parties. Participating in such investment-related services does not disqualify an entity from being an investment entity, even if these services form a substantial part of its business; this is because such services are an extension of its operations.

As regards the provision of other services that are not investment-related services (such as providing strategic advice or financial support to investees), this is one of the factors that differentiates investment entities from other entities. These activities need to be undertaken to maximise investment returns (capital appreciation and/or investment income) from the entity's investees; and they must not represent a separate substantial business activity or a separate substantial source of income. These are covered further in questions 2 and 3 below.

Question 2
Which activities are included under management services for real estate structures?

Answer 2
The permitted activities are [IFRS 10 paras B85C, B85D, BC240]:

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

For Real Estate Structures this would include the management of the structure and the properties within it, acquisitions, arranging external financing, market analysis, strategic decisions, and marketing of assets for lease or sale.

Typical structures would normally use third party service providers like property managers to manage and run the properties, and real estate agents for capital transactions and this would have no impact on whether the investment entities exemption is met. Other Structures would have related service providers, especially in portfolio management, who are remunerated at arm's length.

The amendment states that management services should not be a separate substantial business activity or a separate substantial source of income in order that the investment entities exemption is met.

Question 3

Are there other services allowed other than management services?

Answer 3

For Real Estate Structures it is often the case that financing or guarantees are made or granted to related holding or property companies within the structure. It is not uncommon to see investors provide finance both in the form of equity or loans.

In accordance with IFRS 10 para B85D an investment entity may also participate in the following investment related activities, either directly or through a subsidiary, if these activities are undertaken to maximise the investment return and do not represent a substantial business activity:

- Providing management services and strategic advice to an investee; and
- Providing financial support to an investee, such as loan, capital commitment or guarantee;
- Other incidental services increasing or enhancing the value of investments;
- Other administrative services (that is, accounting at property level).

Business purpose

Question 4

The definition of an investment entity requires that 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.

What are the features of a Real Estate Structure to meet this part of the definition?

Answer 4

For Real Estate Structures, capital appreciation is synonymous with the increase in the fair value of the properties culminating in the gains from disposal whilst rental income from lease contracts is considered as investment income.

Question 5

Where is the business purpose of a Real Estate Structure usually stated?

Answer 5

For a Real Estate Structure, its business purpose is normally presented in offering memorandums, prospectuses, term sheets, partnership agreements, deeds or other corporate documents. The objectives stated are essential in assessing its purpose and whether the entity's purpose is consistent with the business purpose of an investment entity.

See out below an example of a description of a business purpose of an investment entity which meets the criterion:

Real Estate Fund F is a closed ended fund set up for a limited life of 10 years. The mandate and objective of the Fund, set up at inception, is to maximise total returns on capital by seeking consistent recurring income and capital appreciation through the acquiring and realizing of a diverse portfolio of income-producing industrial properties. As such, Fund F will be focused on maximizing the fair value of its investments and rental income growth. The investments are owned through wholly owned property subsidiaries.

Exit strategy

Question 6

Are Real Estate Structures required to have a documented exit strategy for its assets in order to meet the definition of an investment entity?

Answer 6

Yes. An exit strategy is an essential feature of an investment entity. IFRS 10 para B85F states that the fact that the investment entity does not plan to hold its investments indefinitely differentiates it from other entities. An entity's objective of investing for capital appreciation is not generally consistent with an objective of holding the investments indefinitely. As this is a key element of the definition, the presence of an exit strategy is essential evidence of an investment entity's business purpose. Closed ended Real Estate Structures generally have a limited lifetime which is expressed in their offering documents and hence the disposal timeframe is transparent. This can be documented in many different ways and in many different types of documents (for example prospectus, marketing material, investor reports, term sheets, etc.).

Question 7

Is there a time limitation for the exit strategy?

Answer 7

No, there is no guidance within the standard on the period or the number of years for the exit strategy.

Fair value measurement

Question 8

What is meant by 'measures and evaluates the performance of substantially all of its investments on a fair value basis'?

Answer 8

An essential element of the definition of an investment entity is that the entity measures and evaluates the performance of substantially all of its investments on a fair value basis. Accordingly, presenting its investments at fair value results in more relevant information than consolidation or using the equity method (IFRS 10 para B85K).

To meet this criterion an investment entity (IFRS 10 para B85K):

- Provides investors with fair value information;
- Measures substantially all of its investments at fair value in its financial statements whenever it is required or permitted in accordance with IFRS;
- Reports fair value information internally to the entity's key management personnel who use the fair value as the primary measurement attribute to evaluate the performance of substantially all of its investments and to make investment decisions.

Determination of whether the criteria are met therefore requires judgement and has to be performed on a case by case basis. A detailed analysis on the management decision process and on the reporting to investors may be required to understand the primary measurement attributes used.

Question 9

Can a Real Estate Structure that uses measures other than fair value meet the definition of an investment entity?

Answer 9

It depends. Some Real Estate Structures, while having other measures, may still use fair value as their primary measurement attribute to evaluate and make investment decisions. Other Real Estate Structures generating substantial investment income (for example rental income) may not measure and evaluate the performance of substantially all of their investments on the basis of fair value. Management and investors might measure the entity's returns in absolute terms which would include fair value but fair value would not be the sole primary measurement attribute used in making investment decisions. Yield would typically be another primary measurement attribute. In addition, other measures like the internal rate of return, equity multiple, earnings ratio, net present value and EBIDA might be used. This may indicate that the definition of an investment entity is not met and that consolidation or the equity method would provide more relevant financial information.

Typical characteristics of an investment entity

In assessing whether an entity meets the definition described above, it shall consider whether it has the following typical characteristics of an investment entity (IFRS 10 para 28):

a) it has more than one investment;

b) it has more than one investor;

c) it has investors that are not related parties of the entity;

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

The absence of one or more of these typical characteristics does not necessarily disqualify the entity from being an investment entity. But it is highly unlikely that the definition of an investment entity will be met without having any of these typical characteristics (IFRS 10 para BC234). The typical characteristics have to be seen as a supplement to the definition and Real Estate Structures have to consider whether they display these characteristics.

More than one investment

Question 10

If a Real Estate Entity is holding properties via a wholly owned holding company that in turn owns several property companies, is this considered as a single investment?

Answer 10

No. The purpose of an investment entity is to hold several investments to diversify its risk and maximise its return. This condition is met if a Real Estate Entity is investing via a holding company into several properties or several property holding entities (IFRS 10 para B85O).

Question 11

Are there situations where entities qualify as investment entities even if they have just one single investment?

Answer 11

Yes. The purpose under which the Real Estate Structure has been set up has to be taken into consideration. As the Amendment states that the entity holds typically more than one investment it is clear that there are certain situations in which an entity with just one investment could still be considered as an investment entity.

For example, an entity may have just one single investment in the following situations: during its start-up period when it only has seed money available; when it is in course of finding replacements for disposals, or is in the process of liquidation (IFRS 10 para B85P). This may also occur when the entity is established to pool funds from a number of investor's to invest in an investment unobtainable by individual investors like in a club deal to acquire a substantial iconic property in a core location. Typically the investment would be out of reach to any single investor due to its size and risk, but not to a pool of investors.

More than one investor

Question 12

Can a Real Estate Entity be an investment entity with only one investor?

Answer 12

Yes. Typically an investment entity would have several unrelated investors. However, IFRS 10 para B85R permits a single investor that represents or supports the interests of a wider group of investors for example a pension fund or family trust. Other examples include the following situations for the entity [IFRS 10 para B85S]:

a) Is within its initial offering period and the entity is actively identifying other suitable investors;

b) Has not yet identified suitable investors to replace ownership interests that have been redeemed; or

c) Is in the process of liquidation.

Other typical situations may include master-feeder structures where there are multiple investors in the feeder funds.

Unrelated investors

Question 13

If one or more of the investors in a Real Estate Structure are related parties, can the Structure meet the definition of an investment entity? For example, this may arise where the fund manager of a Real Estate Structure has put in the initial seed money and there are, as yet, few if any other investors.

Answer 13

Yes, whilst the amendment does not give much guidance on this characteristic, it does state that typically an investment entity has several investors that are not related parties as defined in IAS 24. If next to the invested fund manager, there are several other investors which are not considered as related parties, the condition is met.

This characteristic was introduced to prevent entities from structuring around the requirement to have more than one investor. The purpose under which the fund has been set up has to be taken into consideration. Furthermore the absence of one or more of the typical characteristics does not necessarily disqualify an entity from being classified as an investment entity.

In addition the Amendment gives an example when an entity qualifies as an investment entity even when all the investors are related (see IFRS 10 para 85U). An investment entity may set up a 'parallel' fund for its key management personnel which mirrors the investments like the main Structure. This fund may qualify as an investment entity.

Ownership interests

Question 14

Could the definition of an investment entity be met if the ownership interests are not in the form of equity?

Answer 14

Yes. Typically the investment entity is a separate legal entity with the result that ownership interests are in form of equity or similar interests (IFRS 10 para B85V), such as participation in an LP, fund units. Nevertheless, the entity might still be an investment entity even if different classes of investors have rights only to specific investments or to a proportionate share of the net assets. These could include partnership interests, investors in Trust structures and structures with different classes of shares or units.

In fund structures the units of the investors often are classified as liabilities. Nevertheless in connection with the analysis these liabilities are considered as similar interests.

In addition, a Real Estate Structure that has significant ownership interests in the form of financing or debt, for example profit participating loans or shareholders loans, may qualify as an investment entity if the holders are exposed to the variable returns from changes in the fair value of the entity's net assets. Consideration is given to the range, scope and extent of the ownership and exposure to variable returns.

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