Project **Annual Improvements**

Topic **IAS 28 *Investments in Associates* – Impairment of investments in associates**

Introduction

Objective of this paper

1. The objective of this paper is to document the staff's analysis and recommendation. The staff will ask the Board whether it agrees with the staff recommendation that impairment testing of investments in associates should be performed for the consolidated financial statements in accordance with IAS 36 *Impairment of Assets* and for the separate financial statements of the investor in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. As such, this paper:

   (a) provides background information on this issue;

   (b) analyses the issue within the context of IFRSs;

   (c) discusses the staff recommendation; and

   (d) asks the Board whether it agrees with the staff recommendations.

Background information

2. In May 2009, the IFRIC deliberated a request to add to its agenda an issue regarding the potentially conflicting guidance in IAS 28 *Investments in Associates*, IAS 36 and IAS 39 when performing an impairment test of investments in associates. The request noted different impairment models (IAS 36 vs IAS 39) are used for impairment testing of investments in associates in the consolidated financial statements vs the separate financial statements of the investor. A copy of the agenda request has been included as Appendix A.

3. At the May 2009 meeting, the IFRIC decided tentatively that IAS 36 provides clear guidance that its requirements apply to impairment losses of investments in associates when the associate is accounted for using the equity method in the consolidated financial statements. However, in its separate financial statements, the investor may account for its investment in an associate at cost.

4. The IFRIC concluded that it is not clear whether in its separate financial statements the investor should determine impairment in accordance with IAS 36 or IAS 39. Therefore, the IFRIC decided tentatively that this issue could best be resolved by referring it to the Board.

Analysis, recommendations and questions for the IFRIC

Consolidated financial statements

5. IAS 28 provides guidance on the accounting for investments in associates in the group consolidated financial statements. One aspect of that accounting for investments in associates is the potential recognition of an impairment loss in the investment.

6. Paragraphs 31-33 of IAS 28 state:

> **Impairment losses**
>
> After application of the equity method, including recognising the associate's losses in accordance with paragraph 29, the investor applies the requirements of IAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.
>
> The investor also applies the requirements of IAS 39 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.
>
> Because goodwill included in the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in IAS 36 *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested under IAS 36 for impairment, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever application of the requirements in IAS 39 indicates that the investment may be impaired…

7. In the staff's opinion, the references to IAS 39 requirements refer to paragraphs 58-62 of IAS 39 that provide guidance on *when* an entity assesses an investment in an associate for impairment and *what* is included as 'objective evidence' detailed in paragraph 59 of that Standard.

8. Once an entity determines there is objective evidence of an impairment in an investment in an associate, paragraph 33 of IAS 28 (included in paragraph 6 above) provides explicit guidance that "the entire carrying amount of the investment is tested under IAS 36 for impairment".

9. In the staff's opinion, the wording in IAS 28 regarding impairment losses is cumbersome; however, the guidance is sufficient. Therefore, the staff does not propose any amendments to IAS 36; however, the staff will incorporate this issue during its review of IAS 28.

Question 1 – Consolidated financial statements
Does the Board agree that, for the consolidated financial statements, impairment losses on investments in associates should be determined in accordance with IAS 36 whenever application of the requirements in IAS 39 indicates that the investment may be impaired?

Separate financial statements

10. As part of the 2003 revisions and 2008 amendments to IAS 27, in paragraph 38 of IAS 27, the Board specified the two allowable accounting models for the measurement in the separate financial statements of the investor of investments in associates are either '(a) at cost or (b) in accordance with IAS 39.' The staff noted diversity exists in practice for impairment testing in the separate financial statements of the investor of investments in associates because of the varied guidance surrounding this issue.

11. While IAS 27 does not explicitly state the meaning of 'in accordance with IAS 39' given that IAS 39 provides for several measurement alternatives (ie cost, amortised cost, fair value through other comprehensive income, or fair value through profit or loss), in the staff's opinion, this refers to the use of fair value through profit or loss. Also, it is the staff's opinion that during the May 2009 IFRIC meeting, the deliberations of the IFRIC appeared to infer the same reference although no formal decision was made by the IFRIC at that meeting.

12. Additionally, IAS 27 does not provide guidance on the meaning of ‘at cost’. Several individual IFRSs provide guidance on how to determine cost with respect to that specific standard, but cost is not defined in the *Glossary*. IAS 39 does include specific guidance on the accounting for financial instruments at cost; however, it is unclear whether IAS 39 is applicable in these situations.

13. More specifically:

    (a) Paragraph 38(a) of IAS 27 states that in the separate financial statements of the investor, the investment in an associate shall be accounted for ‘at cost’, but ‘cost’ is not defined or otherwise clarified within IAS 27.

    (b) In IAS 28 a major heading of ‘Separate financial statements’ includes one paragraph noting ‘An investment in an associate shall be accounted for in the investor’s separate financial statements in accordance with paragraphs 38-43 of IAS 27.’

    (c) IAS 28 provides guidance on impairment losses under the major heading of ‘Application of the equity method’; however, this is in a different heading than the guidance for separate financial statements (see paragraph 10(b)). No guidance is provided within IAS 28 specific to impairment testing of investments in associates for the separate financial statements of the investor.

    (d) IAS 27 provides no specific guidance on the impairment testing of investments in associates for the purpose of reporting the separate financial statements of the investor.

    (e) Paragraph 4 of IAS 36 states, in part, ‘This Standard applies to financial assets classified as…associates, as defined in IAS 28 Investments in Associates…For impairment of other financial assets, refer to IAS 39’. Additionally, paragraph 5 of IAS 36 states, in part, ‘This Standard does not apply to financial assets within the scope of IAS 39…’

    (f) Paragraph 2 of IAS 28 provides a definition that ‘An *Associate* is an entity, including an unincorporated entity such as a partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.’

    (g) Paragraph 2(a) of IAS 39 states that ‘This Standard shall be applied by all entities to all types of financial instruments except those interests in subsidiaries, associates and joint ventures that are accounted for under IAS 27 Consolidated and Separate Financial Statements, IAS 28 Investments in Associates or IAS 31 Interests in Joint Ventures.

However, entities shall apply this Standard to an interest in a subsidiary, associate or joint venture that according to IAS 27, IAS 28 or IAS 31 is accounted for under this Standard. Entities shall also apply this Standard to derivatives on an interest in a subsidiary, associate or joint venture unless the derivative meets the definition of an equity instrument of the entity in IAS 32.'

(h) The Basis for Conclusions on IAS 27 provides insights on the accounting for investments in associates presented in the separate financial statements of the investor. Paragraph BC66 of IAS 27 states (emphasis added):

> Although the equity method would provide users with some profit and loss information similar to that obtained from consolidation, the Board noted that such information is reflected in the investor's economic entity financial statements and does not need to be provided to the users of its separate financial statements. <u>For separate statements, the focus is upon the performance of the assets as investments. The Board concluded that separate financial statements prepared using either the fair value method in accordance with IAS 39 or the cost method would be relevant.</u> Using the fair value method in accordance with IAS 39 would provide a measure of the economic value of the investments. Using the cost method can result in relevant information, depending on the purpose of preparing the separate financial statements. For example, they may be needed only by particular parties to determine the dividend income from subsidiaries.

14. The staff are aware of two views that exist in practice:

(a) **View A** – IAS 36 specifically includes associates as defined by IAS 28 within its scope. IAS 28 refers to IAS 27 for the accounting in the separate financial statements of the investor of an investment in an associate. IAS 27 permits the use of 'at cost' which is not explicitly linked to IAS 39 (whereas the alternative measurement option for an investment in an associate in the separate financial statements does explicitly reference IAS 39). Therefore, 'at cost' must continue to be within the scope of IAS 36 for impairment testing purposes.

(b) **View B** – BC66 of IAS 27 clarified the Board's intentions with respect to the separate financial statements is a focus on the assets as investments. This focus is consistent with investments in financial assets. The primary purpose of IFRSs is for the creation of consolidated general purpose financial statements. The guidance on separate financial statements is limited to 6 paragraphs in all of IFRS. Paragraph 39 of IAS 27 supports the premise that preparation of the consolidated financial statements is the primary purpose of IFRS. The reference in IAS 36 to its applicability to associates as defined in IAS 28 was only meant to apply to the general purpose financial statements. IAS 39 provides guidance on financial instruments 'at cost'. Therefore, given the Board's intentions on separate financial statements 'at cost' is in accordance with IAS 39 including for impairment testing purposes.

15. **In the staff's opinion, View B is appropriate**. Paragraph BC66 of IAS 27 clearly explains the Board's intent that, in the separate financial statements of the investor, investments in associates should be accounted for consistent with the accounting for financial instruments. Given the Board's underlying rationale for separate financial statements, in the staff's opinion, in the separate financial statements of the investor, impairment testing of investments in associates should be performed in accordance with the provisions of IAS 39 for both investments 'at cost' and 'in accordance with IAS 39'.

16. In the staff's opinion:

    (a) if an investor elects to account, in its separate financial statements, for its investment in an associate at fair value through profit or loss, all increases and decreases in the fair value of the investment will be recorded in the statement of comprehensive income at each reporting date, as required by paragraph 55(a) of IAS 39. Therefore, an impairment test will not be necessary.

    (b) if an investor elects to account, in its separate financial statements, for its investment in an associate at cost, for impairment testing purposes, the investor applies paragraphs 58-62 and 66 of IAS 39.

Question 2 – Separate financial statements
2a – Does the Board agree that, for the separate financial statements of the investor, impairment losses on investments in associates accounted for 'in accordance with IAS 39' should be determined in accordance with IAS 39? **2b** – Does the Board agree that, for the separate financial statements of the investor, impairment losses on investments in associates accounted for 'at cost' should be determined in accordance with IAS 39?

Staff recommendation

17. In the staff's opinion, given the different purposes of consolidated financial statements and separate financial statements, different impairment models are appropriate. In the staff's opinion:

(a) IAS 36 is applicable for impairment testing in the consolidated financial statements of investments in associates, and

(b) IAS 39 is applicable for impairment testing in the separate financial statements of investment in associated accounted for either at cost or in accordance with IAS 39.

18. The staff believes that existing IFRSs are not clear regarding the applicable standard for impairment testing of investments in associates held at cost in the separate financial statements of the investor. The staff acknowledges that guidance currently exists to support both View A and View B. As such, the staff recommends this issue for potential inclusion in the exposure draft of *Proposed Improvements to IFRSs* to be published in August 2009.

Question 3 – Proposed issue to annual improvements
Does the Board agree with the staff recommendation that this issue be included in the exposure draft of *Proposed Improvements to IFRSs* to be published in August 2009?

19. Given the staff's desired timing to ballot this issue by 30 June 2009, if approved by the Board for potential inclusion in the exposure draft of *Proposed Improvements to IFRSs* to be published in August 2009, the staff has proposed draft wording for proposed amendments supporting both View A and View B. The proposed wording is set out in Appendix B.

20. As with Agenda Paper 13A, this recommendation is in relation to the current wording of IAS 28 and IAS 39. The project to replace IAS 39 will need to address the unit of account, including whether an entity will be able to designate shares held in an entity into different classifications or whether all such instrument would need to be designated in aggregate. In addition, the joint arrangements project is proposing to recommend changes to accounting for associates. Given those developments the Board might decide that proceeding with a change to IAS 28 now is likely to create more confusion. It might be best to address the matters raised in this paper as part of the FI project and the proposed consequential amendments being developed in the joint arrangements project.

Appendix A – Original IFRIC Agenda Request

Staff overview

A1. In March 2009, the IFRIC received the following agenda request which was deliberated at the May 2009 IFRIC meeting. All information has been copied without modification by the staff.

Agenda request

Submission summary/ cover note

With regard to issue pertaining to IAS 28 as you share the same view that the existence of two standards dealing with impairment would produce different impairment numbers in consolidated and separate financial statements. I don't agree that if an entity carries an investment in associate in its separate financial statements at cost has to look at IAS 39 for impairment; rather they should follow the IAS 36 for potential impairment. Further its my view and depends whether IFRIC share the same that IAS 39 should only be consulted, as in case of equity accounted impairment, only for assessment of impairment indicator both for separate (either at cost or IAS 39) and consolidated and follow the requirement of IAS 36 for detailed calculation of impairment so as to ensure consistency of results in both consolidated as well as separate financial statements.

Submission

The issue

IAS 28- Investment in Associates allows an investor to account for such investment in its separate financial statements using cost or IAS 39 (i.e. Fair value) model. The issue is, if an entity account for such an investments using IAS 39 in its separate financial statements then how entity should assess the impairment in such investments. IAS 28 only provide guidance on impairment related to equity accounted associates and not provide explicit requirement with regard to assessment of impairment of associates accounted for in its separate financial statements using IAS 39 model. This would create different in assessment criteria whereby associates in separate financial statements assessed for impairment using IAS 39 principles and when it comes for consolidated financial statements it assess under IAS 36 for potential impairment. Since both standards have different testing criteria for impairment, it would result in different impairment number result in reporting inconsistency. As per IAS 39 if there is significant or prolonged decline in fair value below cost an equity investment is considered to be impaired whereas IAS 36 compare carrying amount of entire investments to its recoverable amount (i.e. higher of fair value less cost to sell and value in use). Since IAS 39 follow one measure most entities end up recording impairment in separate financial statements whereas it might not record any impairment in consolidated financial statements.

Current practice

Some entities following IAS 36 for both financial statements (i.e. for consolidated and separate) so as to produce consistent result and disclosing it as their policy, while other following IAS 36 for consolidated financial statements and IAS 39 for separate financial statements for investments carried at fair value as per the IAS 39 while entities carrying investments in associates at cost in separate financial statements were recognizing impairment as per IAS 36.

Reasons for the IFRIC to address the issue

Because of wider application of the standard across jurisdiction and apparent inconsistency created through application of both standards, I think IFRIC should establish clear guidance that will ensure consistency in application of the standard. The above issue is also equally prominent in IAS 27 so single guidance will serve the dual purpose i.e. for both associates and subsidiary.

While developing guidance I would appreciate if IFRIC provide any insight why Board has allowed alternative measurement in separate financial statements. I think Board should restrict the application of IAS 39 where the associates or subsidiary held for trading purpose rather as an strategic investment, that is how the inconsistency would best resolved.

Appendix B – Proposed amendment wording

B1. The Staff proposes the following amendment to IAS 27 based on the Board's approval of View A (in the separate financial statements of the investor, for impairment testing of investments in associates accounted for 'at cost', the investor shall apply the provisions of IAS 36).

Proposed amendment to IAS 27 *Consolidated and Separate Financial Statements*

Paragraph 38 is amended (new text is underlined and deleted text is struck through) and paragraphs 38D and 45D are added.

Accounting for investments in subsidiaries, jointly controlled entities and associates in separate financial statements

38 When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:

(a) at cost, or

(b) <u>at fair value through profit or loss</u> in accordance with IAS 39.

The entity shall apply the same accounting for each category of investments. Investments accounted for at cost shall be accounted for in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when they are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5. The measurement of investments accounted for <u>at fair value through profit or loss</u> in accordance with IAS 39 is not changed in such circumstances.

38D When an entity prepares separate financial statements, for the determination and measurement of impairment losses on investments in subsidiaries, jointly controlled entities and associates accounted for at cost, it shall apply the requirements of IAS 36.

Effective date and transition

45D Paragraph 38D was added by *Improvements to IFRSs* issued in [date]. An entity shall apply the amendment prospectively for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Appendix B – Proposed amendment wording (continued)

B2. The Staff proposes the following amendment to IAS 27 based on the Board's approval of View B (in the separate financial statements of the investor, for impairment testing of investments in associates accounted for 'at cost', the investor shall apply the provisions of IAS 39).

Proposed amendment to IAS 27 *Consolidated and Separate Financial Statements*

Paragraph 38 is amended (new text is underlined and deleted text is struck through) and paragraphs 38D and 45D are added.

Accounting for investments in subsidiaries, jointly controlled entities and associates in separate financial statements

38 When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:

(a) at cost, or

(b) <u>at fair value through profit or loss</u> ~~in accordance with IAS 39~~.

The entity shall apply the same accounting for each category of investments. Investments accounted for at cost shall be accounted for in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when they are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5. The measurement of investments accounted for <u>at fair value through profit or loss</u> ~~in accordance with IAS 39~~ is not changed in such circumstances.

38D When an entity prepares separate financial statements, it shall apply the requirements of IAS 39 for the determination and measurement of impairment losses on investments in subsidiaries, jointly controlled entities and associates.

Effective date and transition

45D Paragraph 38D was added by *Improvements to IFRSs* issued in [date]. An entity shall apply the amendment prospectively for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact. If an entity applies the related amendments in paragraphs 2(h)-2(j) of IAS 36 for an earlier period, it shall apply the amendments in this Standard at the same time.

Proposed consequential amendment to IAS 36 *Impairment of Assets*

Paragraphs 2(h) and 2(i) are amended (new text is underlined and deleted text is struck through) and paragraphs 2(j) and 140E are added.

Scope

2 This Standard shall be applied in accounting for the impairment of all assets, other than:

(a) …

(h) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of IFRS 4 *Insurance Contracts*;~~ and~~

(i) non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*<u>; and</u>~~.~~

(j) investments in subsidiaries, jointly controlled entities and associates that are accounted for at cost in the separate financial statements of the investor.

Transitional provisions and effective date

140E Paragraphs 2(h) and 2(i) were amended and paragraphs 2(j) and 140E were added by *Improvements to IFRSs* issued in [date]. An entity shall apply the amendment prospectively for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the related amendments in paragraphs 38 and 38D of IAS 27 for an earlier period, it shall apply the amendments in this Standard at the same time.