30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **March 2009, London**

Project: **IAS 28 *Investments in Associates* – Venture capital consolidations and partial use of fair value through profit and loss (Agenda Paper 5D)**

Introduction

1. In November 2008, the IFRIC received a request to add an item to its agenda to provide guidance on the scope of IAS 28 *Investments in Associates*. Specifically, the IFRIC is requested to clarify instances in which an investor, at a consolidated level, has an investment in an associate, a part of which is held by a subsidiary that is an investment linked insurance fund (or mutual fund, unit trust or venture capital organization). The question raised is whether that part of the investment held by a subsidiary that is an investment linked insurance fund is able to be designated at initial recognition at fair value through profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, while another part of the investment held by another group entity is accounted for in accordance with IAS 28.

2. The purpose of this paper is to:

   A. document the staff analysis and recommendation of the issue for deliberation by the IFRIC, and

   B. ask the IFRIC whether they agree with the staff recommendation.

3. The staff recommendation is not to add this issue to the IFRIC agenda.

Background

4. Paragraph 1 of IAS 28 states:

   This Standard shall be applied in accounting for investments in associates. However, it does not apply to investments in associates held by:

   (a) venture capital organisations, or

   (b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

   that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. Such investments shall be measured at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change.

5. Paragraph 6 of IAS 28 is clear that the determination of significant influence includes both direct and indirect holdings. Paragraph 21 of IAS 28 states that the consolidated group's share in an associate is the aggregate holdings in that associate by the parent and its subsidiaries while the holdings of other associates or joint ventures are ignored for this purpose. See Appendix B for selected excerpts of IAS 28.

6. The request received states that "The standard is however silent on whether or not both those investments included in the scope of IAS 28 and those investments excluded from the scope of IAS 28 should be considered in establishing the existence of significant influence and the group's share in the associate."

7. The request received notes that current practice is divided between two views:

   A. View A – Identify all direct and indirect interests held in the associate by either the parent or any of its subsidiaries and apply IAS 28 to the entire investment in the associate.

   B. View B – Identify all direct and indirect interests held in the associate, but use the scope criteria in IAS 28 to determine the allowed accounting treatments for the investment (or a portion of the investment).

Example

8. Assume Parent company has two wholly-owned subsidiaries (A and B). Subsidiary A holds a 25% ownership interest in an associate and Subsidiary B holds a 20% ownership interest in the same associate. Subsidiary A is a life insurance business and its investment in the associate is held in an investment-linked fund backing its participating life insurance contracts. Subsidiary B is not in the insurance business. Neither of the investments held by Subsidiaries A and B is held for trading.

9. In the individual subsidiaries' financial statements:

   (a) Subsidiary A accounts for its 25% share in the associate at fair value under the fair value option in accordance with paragraph 9(b)(i) in the definition of a *financial asset or financial liability at fair value through profit or loss* of IAS 39.

   (b) Subsidiary B accounts for its 20% share in the associate using the equity method in accordance with paragraph 13 of IAS 28 (or at cost, if the conditions at paragraph 13(c) are met).

Staff Analysis

10. The following paragraphs provide detailed considerations of Views A and B.

View A

11. View A does not take into account the group entity by which the investment is held (i.e. whether a portion of the investment is held in an investment-linked insurance fund), but rather is only concerned with the total investment holdings of the consolidated group.

12. View A is easier to implement as it treats the entire investment in the same manner.

13. Paragraph 37 of IAS 27 *Consolidated and Separate Financial Statements* states that (emphasis added):

> When separate financial statements are prepared, investments in subsidiaries, jointly controlled entities and associates that are not classified

as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 shall be accounted for either:

(a) at cost, or

(b) in accordance with IAS 39.

<u>The same accounting shall be applied for each category of investments</u>. Investments in subsidiaries, jointly controlled entities and associates that are classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 shall be accounted for in accordance with that IFRS.

14. A disadvantage of View A is that it does not consider that there may be different business cases/ intent within a consolidated group (or even within a single entity) for different holdings of the same investment. This disadvantage creates an accounting mismatch in the income statement and balance sheet as the liabilities related to the investment-linked insurance fund are revalued to fair value each reporting period while the asset uses the equity method. This mismatch is a result of different accounting models and not the recording of mismatches in the underlying economics of the investment as the assets that back the liability are matched.

<u>View B</u>

15. View B uses the scope of IAS 28 to group the investment holdings into one of potentially two valuation models (equity method or fair value through profit or loss, or both).

16. View B preserves the characteristics of the business purpose for the investment in the associate.

17. Paragraph 13 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states:

An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a Standard or an Interpretation specifically requires or permits categorisation of items for which different policies may be appropriate. If a Standard or an Interpretation requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

18. Under View B, different categories of investments in associates (for example, “investments supporting insurance contracts” and “investments not supporting insurance contracts” categories) can have different accounting methods applied to them.

19. By analogy, paragraph 25 of IAS 2 *Inventories* states, in part, “… For inventories with a different nature or use, different cost formulas may be justified.” Paragraph 26 of IAS 2 goes on to state, in part, “For example, inventories used in one business segment may have a use to the entity different from the same type of inventories used in another business segment …”.

20. If View B applies, the same issues arise in applying IFRS 5 regarding scope and classification for investments in associates. Under View B, when management’s intent to hold a portion of the investment in the associate changes, the portion that meets the IFRS 5 criteria to be classified as held for sale should be accounted for in accordance with that Standard. The portion of the investment in the associate that continues to be held for a purpose other than sale would continue to be accounted for under the accounting method previously applied (either equity method or fair value through profit or loss).

Staff conclusion

21. The underlying principle of IAS 28 is the notion of significant influence as a result of all direct and indirect investments in an associate. Once a consolidated group has determined it has significant influence over an associate, the entire investment should be accounted for in accordance with IAS 28 (except as excluded by the scope of IAS 28 as discussed in the following paragraph).

22. Paragraph 1 of IAS 28 provides scope exclusions for certain investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities. In the example provided earlier in this paper (see paragraphs 8 and 9), the scope exclusion is not available for the entire investment in the associate. As such, the entire investment is required to be accounted for in accordance with the provisions of IAS 28. Said another way, since the entire

investment in the associate does not meet the scope exclusion, none of the investment in the associate meets the scope exclusion.

23. This notion of all investments in the associate having to be accounted for using the same accounting model is consistent with the provisions of IAS 8. It is also consistent with the notion in IAS 27 of consolidated financial statements presenting the group as a single economic entity.

24. Additionally, paragraph BC8 of IAS 28 states, in part, "…The Board's approach distinguishes between accounting for the investment and accounting for the economic entity. In relation to the former, the Board decided that there should be consistency in the treatment of all investments, including changes in the fair value of these investments."

Staff recommendation

25. Given the current guidance available in IAS 28, the staff recommends that the IFRIC not add the issue to its agenda. The staff has set out the draft tentative agenda decision wording in Appendix A.

Question for the IFRIC

26. Does the IFRIC agree with the staff recommendation and the wording of the draft tentative agenda decision? If not, what does the IFRIC recommend?

[Appendix A is omitted from Observer note]

APPENDIX B – Selected excerpts from IAS 28

Scope

1 **This Standard shall be applied in accounting for investments in associates. However, it does not apply to investments in associates held by:**

(a) venture capital organisations, or

(b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that upon initial recognition are designated as at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. Such investments shall be measured at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change.

Definitions

2 **The following terms are used in this Standard with the meanings specified:**

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.

…

***Significant influence* is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.**

…

Significant influence

6 If an investor holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the investor has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (eg through subsidiaries), less than 20 per cent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

…

Application of the equity method

…

21 A group's share in an associate is the aggregate of the holdings in that associate by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose. When an associate has subsidiaries, associates, or joint ventures, the profits or losses and net assets taken into account in applying the equity method are those recognised in the associate's financial statements (including the associate's share of the profits or losses and net assets of its associates and joint ventures), after any adjustments necessary to give effect to uniform accounting policies (see paragraphs 26 and 27).

…