Project	**IAS 28 *Investments in Associates***
Topic	**Venture capital consolidations and partial use of fair value through profit or loss**

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 IFRIC whether it agrees with the staff recommendation that the use, at the consolidated financial statement level, of the scope exemption within paragraph 1 of IAS 28 for a portion of an investment in an associate is appropriate. As such, this paper:

   (a) provides background information on this issue;

   (b) provides alternative views on the appropriate accounting treatment;

   (c) provides examples for discussion purposes;

   (d) analyses the alternatives within the context of IFRSs;

   (e) discusses the staff recommendation; and

   (f) asks the IFRIC whether it agrees with the staff recommendations.

Background information

2. In March 2009, the IFRIC deliberated a request to add to its agenda a project to provide guidance on the scope of IAS 28 *Investments in Associates*. Specifically, the IFRIC was 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 any entity potentially included within the scope exemption of paragraph 1 of IAS 28). 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 as 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.

3. 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.

4. 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.

5. 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."

Analysis

Alternative views

6. 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)

Examples for discussion purposes

7. Appendix A to this paper includes four examples for discussion purposes with the consistent facts being that there is a Parent company that has two wholly-owned subsidiaries (A and B). 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 and Subsidiary B is not in the insurance business. Neither of the investments held by Subsidiaries A and B is held for trading. The following examples introduce different facts for discussion:

    (a) Example 1 – both investments in the associate result in significant influence on a stand-alone basis

    (b) Example 2 – neither of the investments in the associate results in significant influence on a stand-alone basis

    (c) Examples 3 and 4 – one of the investments in the associate results in significant influence on a stand-alone basis and the other investment in the associate does not result in significant influence on a stand-alone basis

8. All of the examples provide the relevant accounting treatment within the subsidiaries' individual (stand-alone) financial statements. Two alternative views (A and B) will be discussed later in this paper. Under View B, the only accounting policy determined at the subsidiary level that is preserved in the consolidated group financial statements is the accounting policy determined by the subsidiary that meets the scope exception criteria in paragraph 1 of IAS 28. In the staff's opinion, the remaining interests in the associate would be presented

in accordance with the provisions of IAS 28 (ie equity accounting unless some other exception is met).

Staff analysis of the alternative views

9. Two alternative views exist on this issue. The difference between the views is based on differences in the unit of account and whether the accounting policy decisions made by management at the individual subsidiary level could (or should) be preserved during the consolidation process.

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

10. View A considers the unit of account to be all investments in the associate (as determined in accordance with paragraph 21 of IAS 28) regardless of at what level (parent company or a subsidiary) the investment is held within the consolidated group or the type of group entity that holds the investment (i.e. whether a portion of the investment is held in an investment-linked insurance fund).

11. When focusing only on the group level financial statements, View A is easier to implement as it treats the entire investment in the same manner. 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 an IFRS specifically requires or permits categorization of items for which different policies may be appropriate. If an IFRS requires or permits such categorization, an appropriate accounting policy shall be selected and applied consistently to each category.

12. When considering all financial statements presented by entities within the group, View A requires accounting policy decisions made for purposes of the subsidiary's stand-alone financial statement presentation to be reversed for group level consolidated financial statements if the two accounting policy decisions (subsidiary level vs group level) conflict with each other.

13. The required reversal, for the purpose of group level financial statement presentation, of accounting policy decisions made for purposes of the subsidiary's stand-alone financial statement presentation could potentially undermine the accounting policy decisions made with respect to the economic

facts and circumstances specific to that subsidiary's activities (that are likely with the knowledge and approval of parent company management).

14. This required reversal is a disadvantage of View A as it creates an accounting mismatch in the group level income statement and balance sheet. This is because the liabilities related to the investment-linked insurance fund are revalued to fair value each reporting period while the related assets are required to use the equity method (in accordance with the group level accounting policy). The "mismatch" recognised in the group consolidated financial statements is a result of different accounting models (for the linked assets and liabilities). It does not reflect mismatches in the underlying economics of the investment. Rather, the underlying economics are matched by the linked assets and liabilities and the required reversal for group consolidated financial statement presentation is what creates the "mismatch".

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)

15. View B utilises a two-step approach to accounting for investments in associates.

    (a) The first step is to determine all of the direct and indirect ownership interests in the associate (as specified in paragraph 21 of IAS 28). Once it is determined the entity has significant influence, the provisions of IAS 28 apply, as stated in the first sentence of paragraph 1 of IAS 28, "This Standard shall be applied in accounting for investments in associates."

    (b) The second step is to determine the appropriate measurement model(s). The second sentence of paragraph 1 of IAS 28 states, "However, it does not apply to investments in associates held by…"

16. As defined in paragraph 2 of IAS 28:

    > 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.

17. Under View B, an investor still has significant influence over the investee; however, the provisions of IAS 28 do not apply to the investments in associates held by certain types of entities (as specified in paragraph 1 of IAS 28 which is quoted in paragraph 3 of this agenda paper).

18. Therefore, 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).

19. View B preserves the characteristics of the business purpose for which the different the investments in the associate were made (i.e. a portion of the investment may be held for strategic purposes while another portion of the investment may be held as an economic offset to insurance liabilities or other purposes).

20. Under View B, with reference to the consistent application of accounting policies as specified in paragraph 13 of IAS 8 (quoted in paragraph 11 of this agenda paper), 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.

21. View B is similar in principle to paragraph 32A of IAS 40 *Investment Property* which states:

> An entity may:
>
> (a) choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property; and
>
> (b) choose either the fair value model or the cost model for all other investment property, regardless of the choice made in (a).

22. Paragraph 32A of IAS 40 recognizes the potential difference in business purpose for investment property that backs a liability that is linked to an asset as compared to investment properties that are not linked.

23. Additionally, 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 …".

Staff recommendations and questions for the IFRIC

Staff recommendation

24. The staff believes that existing IFRSs are not clear regarding whether View A or View B is appropriate and guidance exists to support both views. As such, the staff does not believe publishing an IFRIC interpretation would be the most effective and efficient way of resolving this issue.

25. Therefore, the staff recommends that the IFRIC not add this issue to its agenda. Rather, the staff recommends that the staff present this issue to the Board for its deliberation and potential inclusion in the exposure draft of *Proposed Improvements to IFRSs* to be published in August 2009.

26. The staff's proposed wording for the tentative agenda decision is set out in Appendix B.

Question 1 – IFRIC agenda
Does the IFRIC agree with the staff recommendation that this issue not be added to the IFRIC agenda? Does the IFRIC agree that the staff should present this issue to the Board for its consideration? If not, why and how should the staff proceed? Does the IFRIC have any comments on the proposed wording for the tentative agenda decision?

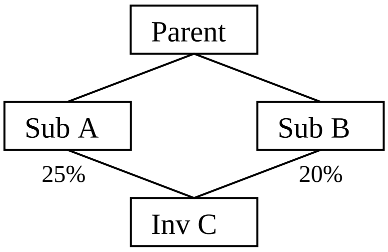
Question 2 – IFRIC recommendations for the Board's consideration
If the IFRIC recommends presenting this issue to the Board, does the IFRIC have a recommended view (A or B) that should be provided to the Board for its consideration? If yes, what is it and why?

Appendix A – Examples for discussion purposes

A1. Example 1 – both investments in the associate result in significant influence on a stand-alone basis.

Assume Parent company has two wholly-owned subsidiaries (A and B).

Subsidiary A, a life insurance business, holds its 25% ownership interest in the associate in an investment-linked fund backing its participating life insurance contracts. Subsidiary B, not in the insurance business, holds a 20% ownership interest in the same associate. Neither of the investments held by Subsidiaries A and B is held for trading.



In the individual subsidiaries' financial statements:

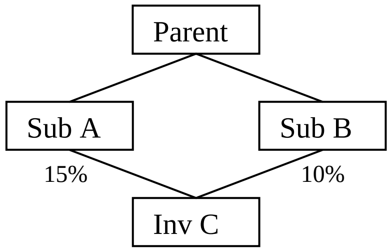
Subsidiary A accounts for its 25% share in the associate at fair value through profit or loss under the fair value option in accordance with paragraph 9(b)(i) in the definition of a *financial asset or financial liability at fair value through profit or loss* of IAS 39.

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).

A2. Example 2 – neither of the investments in the associate results in significant influence on a stand-alone basis.

Assume Parent company has two wholly-owned subsidiaries (A and B).

Subsidiary A, a life insurance business, holds its 15% ownership interest in the associate in an investment-linked fund backing its participating life insurance contracts. Subsidiary B, not in the insurance business, holds a 10% ownership interest in the same associate. Neither of the investments held by Subsidiaries A and B is held for trading.



In the individual subsidiaries' financial statements:

Subsidiary A accounts for its 15% share in the associate at fair value through profit or loss 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.

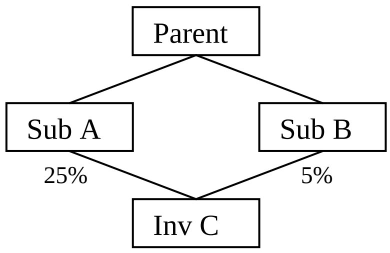
Subsidiary B accounts for its 10% share in the associate using the recognition and measurement provisions of *available-for-sale financial assets* in accordance with IAS 39.

A3. Example 3 – one of the investments in the associate results in significant influence on a stand-alone basis and the other investment in the associate does not result in significant influence on a stand-alone basis.

Assume Parent company has two wholly-owned subsidiaries (A and B).

Assume Parent company has two wholly-owned subsidiaries (A and B). Subsidiary A, a life insurance business, holds its 25% ownership interest in the associate in an investment-linked fund backing its participating life insurance contracts. Subsidiary B, not in the insurance business, holds a 5% ownership interest in the same associate. Neither of the investments held by Subsidiaries A and B is held for trading.

(See also Example 4 for a similar example, but with the ownership percentages switched between the insurance subsidiary and the non-insurance subsidiary.)



In the individual subsidiaries' financial statements:

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.

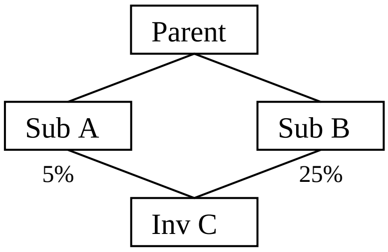
Subsidiary B accounts for its 5% share in the associate using the recognition and measurement provisions of *available-for-sale financial assets* in accordance with IAS 39.

A4. Example 4 – one of the investments in the associate results in significant influence on a stand-alone basis and the other investment in the associate does not result in significant influence on a stand-alone basis.

Assume Parent company has two wholly-owned subsidiaries (A and B).

Subsidiary A, a life insurance business, holds its 5% ownership interest in the associate in an investment-linked fund backing its participating life insurance contracts. Subsidiary B, not in the insurance business, holds a 25% ownership interest in the same associate. Neither of the investments held by Subsidiaries A and B is held for trading.

(See also Example 3 for a similar example, but with the ownership percentages switched between the insurance subsidiary and the non-insurance subsidiary.)



In the individual subsidiaries' financial statements:

Subsidiary A accounts for its 5% 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.

Subsidiary B accounts for its 25% 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).

Appendix B – Tentative agenda decision wording

B1. The Staff proposes the following wording for the **tentative** agenda decision.

> **IAS 28 *Investments in Associates* — Venture capital consolidations and partial use of fair value through profit or loss**
>
> The IFRIC received a request to provide guidance on an issue arising from IAS 28. The issue relates to situations in which a parent has an investment in an associate, one part of which is held by a subsidiary that is an investment-linked insurance fund (or mutual fund, unit trust or venture capital organization). In its separate financial statements, the investment-linked insurance fund subsidiary holding part of the investment in the associate has designated it at initial recognition as at fair value through profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. The other part of the investment in the same associate is accounted for in accordance with IAS 28 using the equity method (or at cost, if certain conditions are met). The issue is whether both measurement bases can be used in the consolidated financial statements.
>
> The IFRIC noted that significant diversity exists in practice on this issue. The IFRIC decided that it could be best resolved by referring it to the IASB [with a recommendation to review and amend IAS 28 by suggested changes to provide guidance for View A or View B as recommended by the IFRIC].
>
> Therefore, the IFRIC [decided] not to add this issue to its agenda.