STAFF PAPER

June 2012

REG IASB Meeting

Project	**Investment Entities**
Paper topic	IAS 28 consequential amendments

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Introduction

1. This paper asks the Board whether to retain the proposals in the IASB Exposure Draft *Investment Entities* ('the ED') regarding the consequential amendments to IAS 28 *Investments in Associates and Joint Ventures*.

2. This paper asks whether the Board wants to:

    (a) require the use of the equity method for an investment entity's investment in an associate or joint venture that provides services to the investment entity;

    (b) require investment entities to measure their investments in associates and joint ventures, other than those which provide services to the investment entity, at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*; and

    (c) remove the existing option to measure investments in associates or joint ventures at fair value through profit or loss in IAS 28 for venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities that are not investment entities.

Summary of staff recommendations

3. The staff recommend that:

   (a) investment entities should be required to measure their investments in associates and joint ventures at fair value through profit or loss, except for their investments in associates and joint ventures which provide services to the investment entity, which should be required to be accounted for using the equity method of accounting; and

   (b) the existing option to measure investments in associates and joint ventures at fair value through profit or loss in IAS 28 should be retained for venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities that are not investment entities.

Background

4. Paragraph 18 of IAS 28 contains the following fair value option:

> When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss in accordance with IFRS 9.

5. As part of their initial deliberations on the ED, the Board decided to remove this option and replace it with a requirement for all investment entities (and only investment entities) to measure their interests in associates or joint ventures at fair value through profit or loss in accordance with IFRS 9. Consequently, venture capital organisations, mutual funds, unit trusts and similar entities that do not meet the definition of an investment entity would be required to use equity accounting for their interests in associates or joint ventures.

6. The ED proposed that an investment entity would measure all of its interests in associates or joint ventures at fair value through profit or loss; that is, it did not

differentiate between an investment entity's interests in entities that provide investment-related services and interests in other types of entities.

7. In the ED's Basis for Conclusions, the Board noted that the investment entities project and the existing fair value option had the same objective—to identify those entities for which fair value measurement of their investments provides more relevant information. The Board also noted that replacing the fair value option with a fair value requirement for investment entities would increase consistency within IFRSs and align IFRSs more closely with US GAAP.

8. Additionally, in proposing that the IAS 28 option be removed for entities that are not investment entities, the Board noted that this would limit the use of fair value measurement in circumstances where it may provide more useful information. They noted that it would be important to gain an understanding of the effect of such a restriction, ie the size of the population currently electing the IAS 28 option that would no longer be eligible for that option, in order to consider the appropriateness of this proposal in the redeliberations of the ED.

9. The FASB proposed Accounting Standards Update, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement and Disclosure Requirements*, proposed that an investment company would be required to measure investments over which it is able to exercise significant influence at fair value rather than use the equity method of accounting, unless that investment is in an entity that provides services to the investment company.[1] Almost all of the FASB constituents supported this proposal and therefore, the FASB staff do not plan to discuss this guidance during the redeliberations.

Feedback received

10. Nearly all constituents agreed with the ED's proposal to require fair value measurement for an investment entity's (as opposed to a non-investment entity's) interests in associates and joint ventures.

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[1] Current U.S. GAAP provides reporting entities an option to measure at fair value equity investments that otherwise would qualify for the equity method of accounting. Under the Accounting for Financial Instruments project, the FASB has tentatively decided that the option would be eliminated. Rather, an entity would be required to classify and measure equity investments that otherwise would qualify for the equity method of accounting at fair value if the investment is 'held for sale'.

11. A few constituents noted that the ED requires an investment entity to consolidate investments in subsidiaries that provide services to the investment entity. Consequently, they suggested that an investment entity should use the equity method rather than fair value for its investment in an associate or joint venture that has provided services to the investment entity.

12. However, the majority of constituents disagreed with the proposed removal of the fair value option in IAS 28 due to the difference in scope between the current option and the proposed new requirement. These constituents stated that many non-investment entities currently use the fair value option in IAS 28. They also noted that it is outside the scope of the investment entities project to change the accounting used by these entities. These constituents provided many examples of entities that are currently electing the fair value option that would not qualify as investment entities under the ED.These examples include:

    (a) Investment funds that have a single investor, single investment or non-unitised ownership interests.

    (b) Investment funds that have other substantive activities besides investing for capital appreciation or investment income.

    (c) Investment funds (or their parents) that receive returns that are more than capital appreciation or investment income from their investees.

13. Constituents noted that these funds are commonly held by entities such as banks, asset managers and insurance companies who retain the fair value accounting that is used by the investment funds at the parent level.

14. Some constituents also felt that the Board and staff needed to perform more research to gain a better understanding of the population of entities that are currently electing the fair value option. Some of these constituents also stated that a full review of the equity method needed to be performed before the existing fair value option was removed.

Staff analysis and recommendation

Accounting by an investment entity for interests in associates and joint ventures

Investment entity's investments in service-providing associates and joint ventures

15. As noted above, the ED proposed that all investments in associates or joint ventures that are held by an investment entity would be required to be measured at fair value through profit or loss. The ED also proposed that an investment entity should consolidate a subsidiary that provides services that relate to the investment entity's own activities only.

16. A few constituents noted an inconsistency between the ED's treatment of investments in subsidiaries that provide services to an investment entity (consolidation) and investments in associates and joint ventures that provide services to an investment entity (fair value). These constituents requested an investment entity to use the equity method to account for interests in associates and joint ventures that provide services to the investment entity.

17. The staff agreed with the constituents' requests and also note that this is consistent with the FASB ED. The staff recommend that an investment entity should be required to use the equity method to account for its investments in associates and joint ventures that provide services to the investment entity.

Mandatory fair value measurement for the rest of an investment entity's investments in associates and joint ventures

18. Except for an investment entity's investments in associates or joint ventures that provide services to the investment entity, the staff continue to think that an investment entity should be required to measure its interests in associates and joint ventures at fair value through profit or loss. This requirement would be consistent with the definition and guidance that the Boards have developed for investment entities. Just as more useful information is provided by requiring investment entities to measure their controlled entities at fair value through profit or loss, more useful information is also provided by requiring them to measure their interests in associates and joint ventures in this way too. The staff also note that

nearly all of the constituents were supportive of the proposed requirement in the ED for an investment entity to measure its investments in associates and joint ventures at fair value through profit or loss. This requirement would also be consistent with the FASB ED.

Question 1
Does the Board agree with the staff recommendation to: a) Require investment entities to measure their investments in associates and joint ventures which provide services to the investment entity using the equity method of accounting? b) Require investment entities to measure all of their other investments in associates and joint ventures at fair value through profit or loss?

Removal of the existing fair value option in IAS 28

19. The staff think that removing the existing fair value option in IAS 28 for the investments in associates of venture capital organisations, mutual funds, unit trusts and similar entities, as proposed in the ED, would improve comparability between entities. The accounting option currently in IAS 28 means that there is a potential for entities to account differently for similar investments in associates and joint ventures.

20. A disadvantage of the proposed removal is that there are entities which qualify for the fair value option in IAS 28 that would not qualify as investment entities and would therefore no longer be able to use the fair value option. As such, they would not be able to measure their investments in associates and joint ventures at fair value and would instead have to use the equity method, even though the fair value measurement may give the most relevant information.

21. The staff note that the definition of an investment entity that was tentatively agreed to by the boards in the May 2012 meeting would potentially resolve some of the issues that were raised by constituents as it allows investment funds with single investors or single investments to qualify as investment entities. However, the staff do not think that all of the entities currently within the scope of the fair value option in IAS 28 will meet this definition. Moreover, the Boards have

decided to require an investment entity to realise returns through capital appreciation for substantially all of an investment entity's investments. It is likely that some entities are currently electing the IAS 28 fair value option for investment funds where a substantial amount of the fund's investments are held for investment income only.

22. The staff think that removing the existing fair value option in IAS 28 is outside the scope of the investment entities project, which was intended to define those entities that should not consolidate controlled entities. The staff also note that, based on the feedback received on the ED, it seems as if the guidance is currently working well in practice.

23. Therefore, the staff recommend that the existing fair value option in IAS 28 should be retained for venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities that are not investment entities.

24. The staff note that, if the Board follows all of the staff recommendations in this paper, there would be two different exceptions to the equity method requirement in IAS 28: a fair value <u>requirement</u> for investment entities and a fair value <u>option</u> for all entities that would currently be eligible for the fair value option in IAS 28 but would not qualify as investment entities. However, for the reasons outlined in this paper, the staff think that this distinction is appropriate.

Question 2
Does the Board agree with the staff recommendation to retain the fair value option in IAS 28 for venture capital organisations, mutual funds, unit trusts, investment-linked insurance funds and similar entities that are not investment entities?