IFRS

STAFF PAPER

29-30 January 2014

IFRS Interpretations Committee Meeting

IFRS IC November 2013

Project	**IFRS 10 *Consolidated Financial Statements***		
Paper topic	Investment Entities Amendments—A non-investment entity's application of the equity method for investment entity investees		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. In July 2013, the IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify some issues related to the Investment Entities amendments to IFRS 10, IFRS 12 and IAS 27. One of the issues is how a non-investment entity should account for investments in a joint venture that is an investment entity.

2. A non-investment entity parent of an investment entity must 'unwind' the fair value accounting of its investment entity subsidiaries and consolidate all subsidiaries in the group in accordance with paragraph 33 of IFRS 10. However, it is not clear whether the non-investment entity must also 'unwind' the fair value accounting of its joint ventures or associates that are investment entities.

Paper structure

3. This paper is organised as follows:

   (a) Submission received;

   (b) Extracts from the Standards

(c) Staff analysis of the issue;

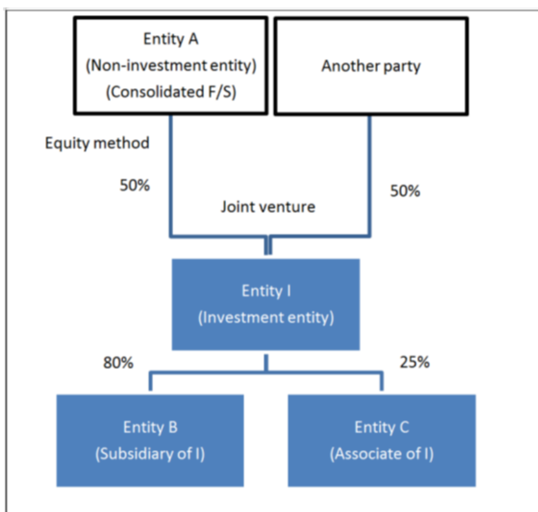
(d) Summary of outreach conducted;

(e) Assessment against the interpretations agenda criteria; and

(f) Staff recommendation.

Submission received

4. The submitter notes that IFRS 10 paragraph 33 states that a parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity. It is therefore clear that when preparing its consolidated financial statements, a non-investment entity parent must 'unwind' the fair value accounting of its investment entity subsidiary and consolidate all subsidiaries in the group. The submitter goes on to note that the Board acknowledged in IFRS 10, paragraph BC283, that this is inconsistent with the exemption in IAS 28 paragraph 18, which allows an entity that indirectly holds an investment in an associate/joint venture through a venture capital organisation to measure that portion of the investment at fair value through profit or loss.



5. Neither IFRS 10 nor IAS 28 provides specific guidance on how a non-investment entity (Entity A) in the example above should account for its interest in an associate/joint venture (Entity I) that is an investment entity. In particular, it is not clear whether the non-investment entity (Entity A), which accounts for the associate/joint venture (Entity I) using equity method accounting, should retain Entity I's fair value accounting or not in Entity A's consolidated financial statements in respect of Entity I's subsidiary, Entity B.

6. The submitter notes that there are two alternative views in practice.

   (a) **View A: in determining its share of the profit or loss of an investment entity associate/joint venture, an entity may retain the fair value accounting applied by that associate/joint venture with respect to its subsidiaries.** The submitter claims that, although the Investment Entity amendments in IFRS 10 specifically note that a non-investment entity parent shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, the Board noted that the difference between using the equity method and fair value measurement for investments in associates and joint ventures is smaller than that between consolidation and fair value measurement for investments in subsidiaries (IFRS 10 paragraph BC283).

   (b) **View B: in determining its share of the profit or loss of an investment entity associate/joint venture, an entity cannot retain the fair value accounting applied by that associate/joint venture to its subsidiaries.** The submitter claims that proponents of this view note that IAS 28 paragraph 35 requires that the financial statements of an investor are prepared using "uniform accounting policies for like transactions and events" for an associate. In addition, they claim that structuring opportunities involving joint venture/associate, such as those noted in IFRS 10 paragraph BC280, may exist.

Extracts from the standards

7. Paragraph 18 of IAS 28 states that an entity may elect to measure an investment in an associate 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 at fair value, instead of applying the equity method.

> 18 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.

8. Paragraph 27 of IAS 28 states that a group's share in an associate or a joint venture is the aggregate of the holdings by the parent and its subsidiaries. The paragraph also states that when an associate or joint venture has subsidiaries or associates, the equity method should be applied to the financial statements of associate or joint venture, which recognises its subsidiaries or associates, after any adjustments necessary to give effect to uniform accounting policies.

> 27 A group's share in an associate or a joint venture is the aggregate of the holdings in that associate or joint venture 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 or a joint venture has subsidiaries, associates or joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's financial statements, after any adjustments necessary to give effect to uniform accounting policies.

9. Paragraphs 35 and 36 of IAS 28 explain the uniform accounting policy requirement for equity method accounting.

> 35 The entity's financial statements shall be prepared using uniform accounting policies for like transactions and events in similar circumstances.

> 36 If an associate or a joint venture uses accounting policies other than those of the entity for like transactions and events in similar circumstances, adjustments shall be made to make the associate's or joint venture's accounting policies conform to those of the entity when the associate's or joint venture's financial statements are used by the entity in applying the equity method.

10. Paragraph 33 of IFRS 10 states that a non-investment entity parent shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary. On the other hand, paragraph 33 does not specify any accounting for associates that are investment entities.

> 33 A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

11. Paragraph BC283 of IFRS 10 states the Board's view that it is important to retain fair value accounting, which is currently allowed under paragraph 18 of IAS 28. On the other hand, the paragraph does not state any intention of the Board to expand fair value accounting under IAS 28:

> BC283 Some respondents to the Investment Entities ED noted that not retaining the fair value accounting of an investment entity subsidiary in its non-investment entity parent's financial statements seems inconsistent with IAS 28 Investments in Associates and Joint Ventures. IAS 28 allows a parent that indirectly holds an investment in an associate through a venture capital organisation, mutual fund, unit trust or similar entity to measure that portion of the investment at

fair value through profit or loss in accordance with IFRS 9 or IAS 39. The Board acknowledged the inconsistency but thought it was important to keep the retention of fair value accounting that is currently allowed for venture capital organisations, mutual funds, unit trusts and similar entities. The Board also noted that the difference between using the equity method and fair value measurement for investments in associates and joint ventures is smaller than that between consolidation and fair value measurement for investments in subsidiaries.

Staff analysis of the issue

12. Paragraph 33 of IFRS 10 requires consolidation by a non-investment entity parent of its subsidiaries but does not specify any accounting for its investments in joint ventures. We would like to consider the following three arguments for the measurement by a non-investment entity (Entity A[1]) of the investees of its investment entity joint venture (Entity B and C) at fair value:

    (a) whether Entity A can consider Entity B and Entity C as indirect associates of Entity A and thus apply the fair value option to Entity B and Entity C;

    (b) whether (non-venture-capital) Entity A can apply the fair value option to its direct investment in a joint venture that is an investment entity; and

    (c) whether Entity A can apply the equity method to the group financial statements of Investment Entity I, which measure Entity B and Entity C at fair value.

[1] This analysis uses the same example as in described in paragraph 4 of this agenda paper.

Whether Entity A can consider Entity B and Entity C as indirect associates of Entity A and thus apply the fair value option to Entity B and Entity C

13. Paragraph 27 of IAS 28 states that "A group's share in an associate or a joint venture is the aggregate of the holdings in that associate or joint venture by the parent and its subsidiaries. The holdings of the group's other associates or joint ventures are ignored for this purpose." Paragraph 27 of IAS 28 also states that "When an associate or a joint venture has subsidiaries, associates or joint ventures, the profit or loss, other comprehensive income and net assets taken into account in applying the equity method are those recognised in the associate's or joint venture's financial statements."

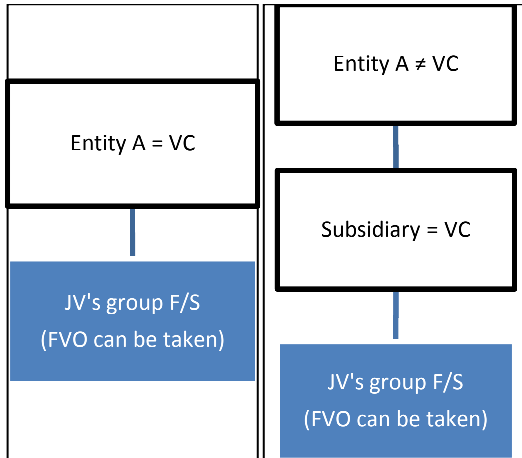
14. Accordingly, we think that Entity B and Entity C should not be separately treated as indirect associates of Entity A because they are Entity A's investments. Entity A cannot apply the fair value option to Entity B and Entity C separately. Instead, Entity A should use the group financial statements of Investment Entity joint venture I, in order to incorporate the financial statements of Entity B and Entity C.

Whether (non-venture-capital) Entity A can apply the fair value option to its direct investment in a joint venture that is an investment entity

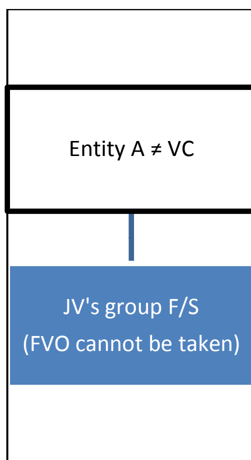
15. As discussed above, if a joint venture has investees (subsidiaries or associates), the group financial statements of the joint venture should be used as the basis for equity accounting.

16. Paragraph 18 of IAS 28 states that "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." Accordingly, we think that the fair value option can be taken by the following structures in which an investment in a joint venture (JV) is held by, or is

held indirectly through, an entity that is a venture capital or similar organisation (VC):



However, we think that the fair value option cannot be taken by the following structure presented in the submission, because the joint venture is not held by, or is not held indirectly through, an entity that is a VC, even if the joint venture itself is a VC that is eligible to apply the fair value option. In addition, a subsidiary of the VC joint venture is not considered to be held indirectly through the VC as well, because a joint venture and its subsidiary should not be separately treated, in accordance with paragraph 27 of IAS 28, as we discussed in paragraph 14 of this agenda paper.



Whether Entity A can apply the equity method to the group financial statements of Investment Entity I, which measures Entity B and Entity C at fair value

17. We consider that Entity A cannot apply the equity method to the group financial statements of Investment Entity I, which measures Entity B and Entity C at fair value, for the following reasons:

    - Before the Investment Entities amendments were issued, IAS 28 allowed fair value measurement of JV only when the holding entity of JV met the VC condition and chose the fair value option in accordance with paragraph 18 of IAS 28. If the application of the equity method to the fair value-based group financial statements of Investment Entity I was allowed, the non-VC Entity A could effectively measure investments in associates or JVs at fair value, which was not allowed under IAS 28, as discussed on the previous paragraph of this agenda paper. BC283 states that the Board retained the above fair value option because it thought that it was important to retain the fair value accounting that was allowed at that time. On the other hand, the Investment Entities amendment did not state any intention by the Board to expand the fair value accounting under IAS 28 as a result of the Investment Entities amendments.
    - It would also be misleading if the equity method is used as an accounting policy but the accounting consequence is the same as for the fair value option. A venture capital entity has an accounting policy choice: fair value option or equity method. The policy choice is stated in the footnote disclosure. The consequences of the accounting policy choice (fair value option or equity method) gives different results and we think users should be notified which accounting policy is used, in order to understand the financial statements. When an entity states 'equity method' as an accounting policy, rather than the fair value option, we do not think users of the financial statements expect fair value-based accounting to be applied for associates and joint ventures. However, if an entity can apply the equity method to fair value-based financial statements of an investment entity, the accounting consequence of

applying the equity method to the investment entity financial statements could be similar to that of fair value option.

- In accordance with paragraph 27 of IAS 28, the equity method is applied to the associate's or joint venture's financial statements "after any adjustments necessary to give effect to uniform accounting policies" (paragraph 35 and 36). If the financial statements of the associate are prepared using a different accounting policy or are prepared based on different accounting standards, entities need to adjust their financial statements accordingly. Paragraph 35 would be applicable to the equity method of accounting applied to the financial statements of investment entities. Consequently, the financial statements of Entity I should be adjusted on the basis of consolidating a subsidiary on a line-by-line basis as opposed to recognising the investment in the subsidiary and measuring it at FV.

On the basis of the analysis above, we consider that Entity A should unwind the fair value accounting of Entity I before applying equity method, in accordance with paragraphs 35 and 36 of IAS 28.

Summary of outreach conducted

18. We asked IOSCO, ESMA and national standard-setters to provide information on the issue raised in the submission by posing the following questions to them:

    (a) *Q1. How common are each of these issues? If these are common, could you provide us with information that the Interpretations Committee could use to assess how widespread the issues are?*

    (b) *Q2. In your view, is there diversity in practice in interpreting each issue? Please describe the predominant approach that you observe in practice.*

Responses from regulators and national standard-setters

19. We received responses from the following 14 jurisdictions: Europe (4), Asia (3), Americas (3), Oceania (1), Africa (1) and International (2).

20. Most of the respondents stated that they have limited experience of the Investment Entities amendments, because entities are not required to apply the amendments until the annual period on or after 1 January 2014. Most of the respondents did not make specific comments on this issue. Some respondents commented that the Standards could be read in different ways in relation to the issue.

Assessment against the interpretations agenda criteria

Agenda criteria	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected.	**No.** Entities are not required to apply the amendments until the annual period on or after 1 January 2014. Accordingly, the issue is not common in all jurisdictions at this point. In addition, on the basis of the outreach, we do not think that this issue would be widespread.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods.	**No.** We think that the existing paragraphs 27, 35 and 36 of IAS 28 provide sufficient guidance.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**Not applicable.** We think that the existing paragraphs 27, 35 and 36 of IAS 28 provide sufficient guidance.
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (5.17)?	**Not applicable.** We think that the existing paragraphs 27, 35 and 36 of IAS 28 provide sufficient guidance.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	**Yes.** The issue does not relate to a current or planned IASB project.

Staff recommendation

21. We recommend that the Interpretations Committee should not take this issue onto its agenda, because the existing paragraphs 27, 35 and 36 of IAS 28 sufficiently address the issue. We noted that paragraph 27 of IAS 28 requires that entities should apply the equity method to the group financial statements of joint venture, when the joint venture has a subsidiary and an associate. In addition, paragraph 27 of IAS 28 requires that the entity should apply equity method to the joint venture's financial statements, after making any adjustments necessary to give

effect to uniform accounting policies in accordance with paragraphs 35 and 36 of IAS 28.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree that the non-investment Entity A should unwind the fair value accounting of its investment in the investment entity joint venture before applying equity method, in accordance with paragraphs 27, 35 and 36 of IAS 28?   2. Does the Interpretations Committee agree with the staff's recommendation that the Interpretation Committee should not take this issue onto its agenda?   3. Does the Interpretations Committee have any comments on the proposed wording in Appendix A for the tentative agenda decision?

Appendix A—Proposed wording for tentative agenda decision

A1 The proposed wording for the tentative agenda decision is presented below.

***IFRS 10 Consolidated Financial Statements: Investment Entities Amendments*—A non-investment entity's application of the equity method for investment entity investees.**

The Interpretations Committee received a request to clarify whether an entity that is not an investment entity should apply equity method accounting for its investment in a joint venture that is an investment entity.

The Interpretations Committee noted that if the application of the equity method to the fair value-based financial statements of investment entity is permitted/required, entities would be able to apply fair value accounting to a joint venture or an associate, without applying fair value options in IAS 28. Paragraph BC283 of IFRS 10 *Consolidated Financial Statements* (2012) states that the Board's intention to retain the existing fair value option, however, it does not state any intention by the Board to expand the fair value accounting under IAS 28.

The Interpretations Committee also noted that in accordance with paragraph 27 of IAS 28, the equity method is applied to the associate's or joint venture's financial statements "after any adjustments necessary to give effect to uniform accounting policies" (paragraph 35 and 36). If the financial statements of the associate are using a different accounting policy or are prepared based on different accounting standards, entities need to adjust their financial statements accordingly. Paragraph 35 would be applicable to the equity method accounting applied to the financial statements. If a non-investment entity invests in an investment entity joint venture, the non-investment entity should 'unwind' the fair value accounting of the investment entity joint venture before applying equity method, in accordance with paragraph 35 and 36 of IAS 28.

The Interpretations Committee considered that in the light of its analysis of the existing IFRS requirements, IAS 28 contains sufficient guidance and neither an interpretation nor an amendment to a Standard was necessary. Consequently the Interpretations Committee [decided] not to add the issue to its agenda.