STAFF PAPER

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IASB Meeting

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Project	**Narrow-scope amendments to IAS 28 *Investments in Associates and Joint Ventures***
Paper topic	Investment Entities Amendments—application of the equity method by a non-investment entity investor to an investment entity investee

CONTACT(S) Koichiro Kuramochi kkuramochi@ifrs.org +44 (0)20 7246 6496

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Introduction

1. In January 2014, the IFRS Interpretations Committee ('the Interpretations Committee') discussed a request to clarify 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 *Consolidated Financial Statements*. 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.

3. The Interpretations Committee discussed the issue in its January 2014 meeting, but it did not reach a consensus. As a result of the staff's feedback to the IASB at its last meeting, the IASB asked the staff to bring a paper on the issue to the March IASB meeting because of the need to clarify the issue quickly for implementation this year.

Purpose of this paper

4. The objective of this paper is to:

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(a) present background information on the issue;

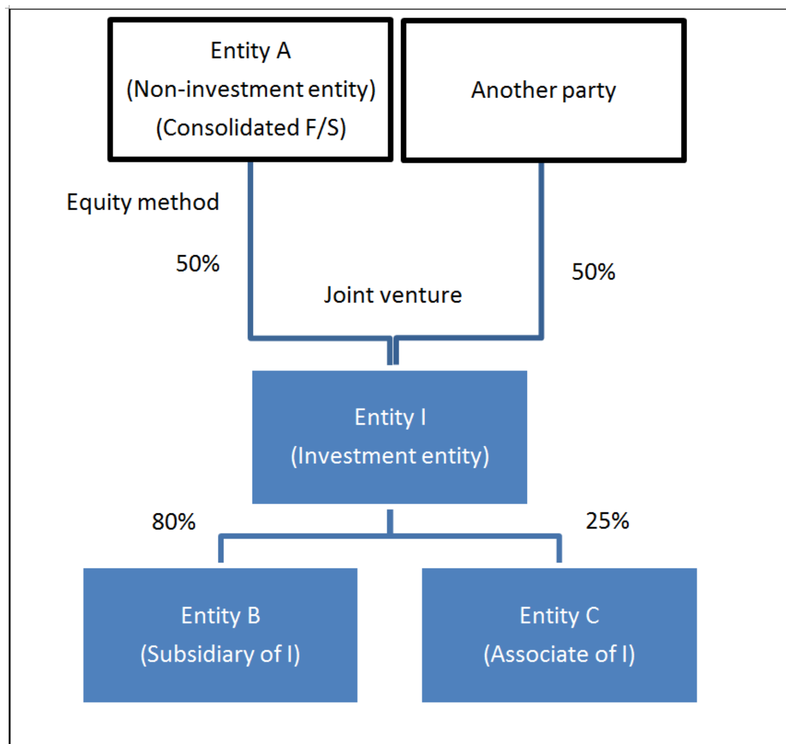
(b) provide a summary of the Interpretation Committee's discussions; and

(c) set out the staff's rationale for recommending that the IASB should amend IAS 28 *Investments in Associates and Joint Ventures*.

Background information

5. Paragraph 33 of IFRS 10 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.

6. IAS 28 does not contain an equivalent explicit statement. Consequently, the Interpretations Committee was asked to consider the following example.



7. Neither IFRS 10 nor IAS 28 provide 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 in Entity A's consolidated financial statements in respect of Entity I's subsidiary, Entity B.

Staff analysis of the issue

8. 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 Entity 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 (Entity I), which is an investment entity; and

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

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

9. 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

[1] This analysis uses the same example as described in paragraph 6 of this Agenda Paper.

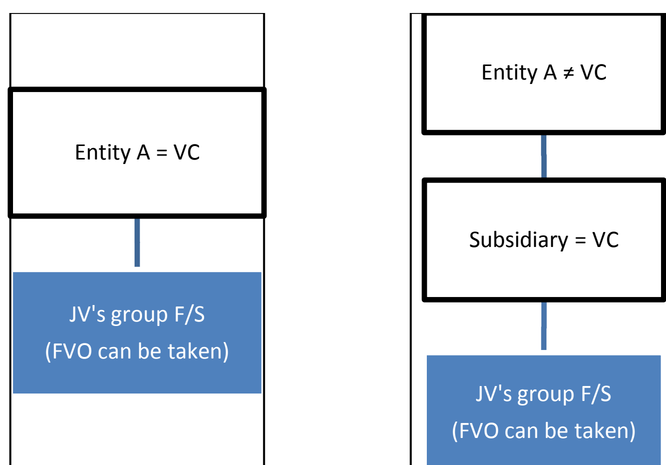
account in applying the equity method are those recognised in the associate's or joint venture's financial statements.'

10. 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 Entity I, in order to incorporate the financial statements of Entity B and Entity C using the equity method.

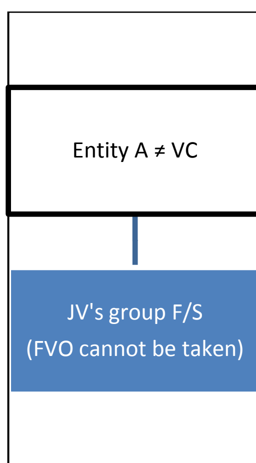
Whether (non-venture-capital) Entity A can apply the fair value option to its direct investment in a joint venture (Entity I) that is an investment entity

11. 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.

12. 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 organisation 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, and 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 9 of this agenda paper.



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

Alternatives for application of the equity method by a non-investment entity investor to an investment entity investee

13. We discussed with the Interpretations Committee two alternative approaches to applying the equity method by a non-investment entity investor to an investment entity investee as follows:

Alternative 1: a non-investment entity investor **cannot retain** the fair value accounting applied by that investment entity **associate/joint venture**, when applying the equity method.

Alternative 2: a non-investment entity investor **should retain** the fair value accounting applied by that investment entity **associate/joint venture**, when applying the equity method

***Alternative 1**: a non-investment entity investor **cannot retain** the fair value accounting applied by that investment entity **associate/joint venture**, when applying the equity method*

14. Alternative 1 is consistent with the decision made by the IASB for a non-investment entity parent of an investment entity subsidiary. The exception to the consolidation requirement was introduced because of the unique business model of investment entities. The IASB was concerned that a non-investment entity parent could achieve different accounting outcomes by holding subsidiaries directly or indirectly through an investment entity. Paragraphs BC278–BC280 of the Basis for Conclusions on IFRS 10 state the IASB's view as follows (emphasis added):

> BC278 **The Board has decided to provide an exception to consolidation because of the unique business model of investment entities. Non-investment entities do not have this unique business model**; they have other substantial activities besides investing, or do not manage substantially all of their assets on a fair value basis. Consequently, **the argument for a fair value measurement requirement is weakened at a non-investment entity level**.
>
> BC279 The Board also noted that the decision to define an investment entity and describe its typical characteristics rather than requiring an investment entity to meet a number of criteria has increased the population of entities that could qualify as investment entities, and has also increased the amount of judgement needed to determine whether an entity is an investment entity. For example, an entity with a single investor, or an entity that provides day-to-day management services or strategic advice to its subsidiary, can qualify as an investment entity under this IFRS, when such entities would have been excluded under the Investment Entities ED.

> BC280 **The Board was concerned that some of these changes would increase the likelihood that a non-investment entity parent could achieve different accounting outcomes by holding subsidiaries directly or indirectly through an investment entity. The Board noted that, for example, a non-investment entity parent may elect to hold subsidiaries through an investment entity subsidiary in order to hide leverage or loss-making activities.**

Although the investee in the submission (Entity I) is not a subsidiary but is instead a joint venture, we believe that the same argument could be made for a joint venture or an associate investee of a non-investment entity investor or joint venturer.

Similarity of outcome between the fair value option and the equity accounting using the fair value based financial statements.

15. The accounting consequence of applying the equity method to the fair value based financial statements of an investment entity joint venture or associate would be very similar to using the fair value option. This would, effectively, expand the fair value accounting available in IAS 28. We think that this would be an unintended consequence of the amendments in *Investment Entities*. Before *Investment Entities* was issued, IAS 28 allowed fair value measurement of a joint venture only when the holding entity of the joint venture met the VC condition and chose the fair value option in accordance with paragraph 18 of IAS 28.

16. Although paragraph BC283 of the IFRS 10 states that the IASB retained the fair value option because it thought that it was important to retain the fair value accounting that was allowed at that time, it does not state any intention by the IASB to expand the use of fair value accounting permitted by IAS 28 (see paragraph 23).

Clarity about the accounting policy applied

17. Paragraph 21(b)(i) of IFRS 12 *Disclosure of Interests in Other Entities* states as follows (emphasis added):

> 21 An entity shall disclose:
>
> (a)…
>
> (b) for each joint venture and associate that is material to the reporting entity:
>
> (i) whether the investment in the joint venture or associate is measured using **the equity method or at fair value.**

A venture capital entity has an accounting policy choice: fair value or the equity method. The policy choice is stated in the footnote disclosure. Because the consequences of the accounting policy choice (fair value option or equity method) give different results, 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.

18. However, if an entity can apply the equity method to the fair value-based financial statements of an investment entity associate/joint venture, the accounting consequences of applying the equity method to the investment entity financial statements could be similar to the consequence of applying the fair value option. We think that this risks confusing the users of the financial statements.

Alternative 2*: a non-investment entity investor should* ***retain*** *the fair value accounting applied by that investment entity* ***associate/joint venture****, when applying the equity method*

19. Paragraph 33 of IFRS 10 specifically notes that a non-investment entity parent shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary. The amendments in *Investment Entities* did not make any consequential amendments to IAS 28. Therefore, there is no equivalent explicit statement in IAS 28 to make it clear that the unwinding of the fair value accounting used by the investment entity associate/joint venture is required. It is argued that this means that the unwinding of the fair value accounting is not required. In addition, this view could be supported because the IASB 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. This is set out in paragraph BC283 of IFRS 10 as follows (emphasis added):

> 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.**

20. Advocates of retaining the fair value accounting argue that paragraph 27 of IAS 28 permits a non-investment entity investor to use the fair value accounting for the net assets that are recognised in the associate's or the joint venture's financial statements and no adjustments are needed to give effect to uniform accounting policies. In accordance with paragraph 27 of IAS 28 (emphasis added):

> "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 (see paragraphs 35 and 36).

Staff analysis on the alternatives

21. We support Alternative 1 on the basis of the arguments presented.

22. We do not agree with the arguments in Alternative 2. We think that the scope of the amendment in *Investment Entities* was restricted to providing an exception to consolidation for investment entity parents. Investment entity investors could already apply the fair value option in IAS 28 as an alternative to using the equity method for investments in associates and joint ventures. Consequently, the IASB only discussed the unwinding of the fair value accounting for an associate or a joint venture in the specific context mentioned in paragraph BC283 of IFRS 10. This was in response to a proposal in the Exposure Draft *Investment Entities*, published August 2011, to replace any reference to 'venture capital organisations, mutual funds, unit trusts and similar entities' with 'investment entity'. This would have reduced the number of entities for which the fair value option in IAS 28 would have been available, because the definition of an investment entity is narrower than 'venture capital organisations, mutual funds, unit trusts and similar entities'.

23. We also think that paragraphs 35-36 of IAS 28 would be applicable to give effect to uniform accounting policies. As noted in paragraph 36 of IAS 28 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'.

The Interpretations Committee's view

24. At the January 2014 meeting, the Interpretations Committee members discussed Alternative 1 and Alternative 2. The Interpretations Committee members expressed mixed views on this matter.

25. Some of the Interpretations Committee members agreed with the staff's conclusion that Alternative 1 applies and thought that the concerns described in paragraphs BC 278–BC280 would also be applicable to an associate or a joint venture. Other Interpretations Committee members emphasised the practical difficulties in receiving sufficient information from an associate or a joint venture, in order to unwind fair value accounting of an investment entity associate or joint venture.

26. The Interpretations Committee were unable to reach a conclusion at the January 2014 meeting. The Interpretations Committee noted that the staff plan to start discussions on its research project on the equity method of accounting in May 2014. Consequently, the Interpretations Committee asked that the staff report back to the Interpretations Committee following the IASB's initial discussions on the research project and were unable to reach a conclusion at the January meeting. However, at its February 2014 meeting, the IASB asked the staff to bring a paper on the issue to the March IASB meeting because of the need to clarify the issue quickly for implementation this year.

Staff's further analysis

27. If a parent entity has control of its investees, the parent entity can require its investees to provide accounting records in order to consolidate the investees. However, if an investor only has significant influence over an investee, the investor may have practical difficulties in requiring the associate to provide accounting records to apply the equity method to the historical-cost consolidated information of the investment entity associate. We note the Interpretations Committee's concerns about this practicality issue and discuss another alternative approach (Alternative 3) to take this into account.

***Alternative 3**: a non-investment entity joint venturer **cannot retain** the fair value accounting applied by that investment entity **joint venture**; however, a non-investment entity investor should **retain** the fair value accounting applied by that investment entity **associate,** when applying the equity method*

28. We think that an investment entity associate or a joint venture should unwind fair value accounting applied, if we apply the logic described in paragraphs 13-18 of this paper. We note that the equity method 'uniform accounting policy' requirement (paragraphs 27 and 35-36 of IAS 28) does not contain any exception based on the practical difficulty that an investor might have in gathering information from associates. On the other hand, we understand the practicality issues related to unwinding the fair value accounting, which were highlighted by the Interpretations Committee. However, we think that the degree of practical difficulty is different depending on whether the investee is an associate or a joint venture. A joint venturer has joint control and, consequently, we think, should have more power to request accounting records to apply the equity method, compared with investors that only have significant influence over investment entity associates.

29. We also acknowledge the IASB's concerns about the structuring risks highlighted in paragraph BC280 of the Basis for Conclusions on IFRS 10 (see paragraph 14 of this paper). We think that an investor's ability to achieve different accounting outcomes by holding investments through an investment entity investee is different depending on whether the investee is an associate or a joint venture. A joint venturer has joint control of its joint venture and should have more power to achieve such an outcome than an investee with only significant influence over an associate.

30. We note that IAS 28 does not require any different accounting between an associate and a joint venture. However, we think that the different practical difficulties, and the different levels of risk relating to achieving different accounting outcomes by holding investments through an investment entity investee, suggest that it could be appropriate to differentiate the required accounting between an associate and a joint venture in this particular case. IAS 28 currently does not make such a distinction and, consequently, an amendment to IAS 28 would be required in order to facilitate this Alternative 3.

Staff conclusion and recommendation

31. We think that from the perspective of how we read the standards as currently written and our understanding of the IASB's discussions at the time of developing the investment entities amendment, a non-investment entity should apply the equity method to the financial statements of investment entity associates and joint ventures in accordance with Alternative 1.

32. We note that when an investment in an associate or 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 (a VC entity), the non-investment entity can apply the existing fair value option in IAS 28 in order to measure the investment entity associate or joint venture at fair value. When an investment in an associate or a joint venture is not held by, or is not held indirectly through, a VC entity, we think that the entity is not permitted to apply the fair value option and should apply the equity method to those investees. Consequently, in accordance with Alternative 1, we think that the current equity method procedures in IAS 28 require the entity to 'unwind' the fair value accounting of its investment entity associates and joint venture before applying the equity method.

33. From a practical perspective, we fully understand the cost/benefit arguments raised by the Interpretations Committee in support of permitting the use of fair value based financial statements for equity accounting proposes. We can also see the argument made that there is greater concern about structuring in the case of joint ventures that are investment entities, and thus we can see a basis for supporting Alternative 3 (ie to allow the equity accounting of associates only to be based on the fair value financial statements of those associates). We acknowledge that this approach would reduce the cost burden and practical difficulties involved in unwinding the fair value accounting of the associate, without unduly increasing the risk of structuring opportunities designed to achieve different accounting outcomes.

34. However, we have based our recommendation solely on our technical analysis of the Standards as currently written and our understanding of the IASB's discussions at the time of developing the investment entities amendment.

Consequently, we recommend that IAS 28 is amended to make the requirement to unwind the fair value accounting more explicit, as has been done in IFRS 10 (ie in accordance with Alternative 1). This would add clarity to the existing requirements and reduces the risk of diversity developing in practice.

35. We also recommend that any amendment to IAS 28 arising from this issue is combined with other proposed narrow-scope amendments to IFRS 10 that are being discussed in this meeting.

Questions for the IASB

Questions for the IASB
Does the IASB agree to amend IAS 28? If so, does it agree with our recommendation to amend it in accordance with Alternative 1?