# STAFF PAPER

November 2014

## IFRS Interpretations Committee Meeting

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| **Project** | **IAS 28 *Investments in Associates and Joint Ventures*** |
| Paper topic | Applying the fair value option: an investment by investment choice or a consistent policy choice |

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## Introduction

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the application of the fair value option by a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds. The question is whether the application of the fair value option is an investment-by-investment choice or a consistent policy choice.

## Paper structure

2. This paper is organised as follows:

   (a) submission received;

   (b) extracts from the Standards;

   (c) summary of outreach conducted;

   (d) staff analysis of the issue;

   (e) assessment against the interpretations agenda criteria; and

(f) staff recommendation.

## Submission received

3. When an investment in an associate or a joint venture is held by, or is held indirectly through, a venture capital organisation etc, the entity may elect to measure investments in those associates and joint ventures at fair value through profit or loss (the fair value option), in accordance with paragraph 18 of IAS 28 *Investments in Associates and Joint Ventures*.

4. The Interpretations Committee received a request to clarify whether the entity is able to choose between applying the equity method, or measuring an investee at fair value on an investment-by-investment basis, or whether instead the accounting treatment should be applied consistently across all its investments.

5. The submitter noted that the IASB had revised IAS 28 in 2011. Before the revision, the fair value option appeared as a scope exemption in IAS 28; however, that paragraph was moved to the body of IAS 28 as a result of the revision. The submitter claims that before the revision in 2011, entities had an explicit option whereby they could choose to measure investees using the equity method, or the fair value option, on an investment-by-investment basis. However, after the revision, it had become less obvious whether the entity still has the same option.

6. According to the submitter, two views exist as follows:

(View A) An entity can elect to account for investments either by the equity method or the fair value option on an investment-by-investment basis, because no change was discussed by the IASB or described in the guidance or Basis for Conclusions relating to the application of the fair value option when IAS 28 was revised in 2011; or

(View B) an entity needs to apply the fair value option consistently across all its investments, because the option included in the revised IAS 28 that allows either the equity method or the fair value option through an accounting policy election does not specify that the fair value option is available on an investment-by-investment basis.

### Extracts from the Standards

7. In 2003, the IASB revised IAS 28 and introduced the fair value option as a scope exemption to the IAS 28. IAS 28 (2003) stated that the Standard did not apply to investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds, if those investments are designated as at fair value through profit or loss (FVTPL) upon initial recognition, or if they are classified as held for trading and are consequently accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. IAS 28 (2003) states the fair value option as follows (emphasis added):

> 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.

8. IAS 28 was revised in 2011. The paragraph on the fair value option was moved to the body of IAS 28 and the wording was modified. IAS 28 (2011) states the fair value option as follows (emphasis added):

> 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.

9. Paragraph 13 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* describes the principle that an entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless other Standards *specifically* requires or permits categorisation of items for which different policies may be appropriate. Paragraph 13 of IAS 8 states (emphasis added):

> 13 An entity shall select and apply its accounting policies *consistently* for similar transactions, other events and conditions, *unless an IFRS specifically requires or permits categorisation of items for which different policies may be appropriate*. If an IFRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

10. Paragraph 35 of IAS 8 states that a change in the measurement basis applied (eg fair value or historical cost) is a change in accounting policy:

> 35 A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate.

## Summary of outreach conducted

11. We have performed outreach with the securities regulators, IFASS members, and global accounting firms. Specifically, we asked the following questions:

    Q1. Are you aware of examples of application of the fair value option to associates and joint ventures by venture capital organisations, or a mutual funds, unit trusts and similar entities including investment-linked insurance funds?

    Q2. If yes to Q1, please would you:

(a) inform us about the extent to which the fair value option applied in your jurisdiction;

(b) describe the basis on which the fair value option is applied in your jurisdiction. For example, is the option generally applied on an investment-by-invest basis or generally applied to all associates and joint ventures held by venture capital organisations, or a mutual funds, unit trusts and similar entities including investment-linked insurance funds, or applied on some other basis?;

(c) provide us with examples that illustrate the practices that you observe and the reasons for the practice followed?

12. We received 15 responses from 2 securities regulators, 10 IFASS members and 3 global accounting firms.

13. By region, we received the 15 responses from the following jurisdictions: Asia (2), Africa (1), Americas (3), Europe (3), Oceania (2), and International (4).

14. Most of the respondents were aware of examples of the application of the fair value option to associates and joint ventures in their jurisdictions. Other respondents stated that the applications of the fair value option is not common in their jurisdictions.

15. About half of those who were aware of the application of the fair value option stated that the fair value option is applied consistently to all its investments or on a ‘class’ basis. About half of those who were aware of the application of the fair value option stated that they are aware of mixed practice; some issuers apply the fair value option on an investment-by-investment basis, while others apply the fair value option consistently.

16. We received the following feedback with regard to the mixed practice:

(a) One respondent observed a mixed approach only in extremely rare cases, in which fair value could not be reliably estimated for some associates or joint ventures. Entities were precluded from designating such associates as investments accounted for at fair value through profit or loss on the basis of guidance in IAS 39. Such investments have been accounted for using the equity method.

(b) Another respondent stated that, in some jurisdictions, the fair value option is applied as a policy choice—ie it is seen as a requirement to be applied to all investments in associates and joint ventures, not on an investment-by-investment basis. However, issuers in other jurisdictions seem to apply the fair value option on a 'class' basis; for example, indirectly held insurance fund/unit trust associates are all accounted for at FVTPL, but any non-fund associates are accounted for using the equity method.

(c) A further respondent commented that, in many jurisdictions, the fair value option is applied consistently across all the investments. However, in other jurisdictions, the fair value option is not necessarily applied to all the investments. In particular, the equity method is applied to an associate if the associate is considered to be an extension of the business of the investor, while other investees are measured at fair value.

## Staff analysis of the issue

### *Analysis of how the current wording was developed*

17. We analysed how the current wording in IAS 28 was developed as follows:

***IAS 28 revised in 2003***

18. We noted that paragraph 1 of IAS 28 (2003) stated that the Standard does not apply to investments in associates that 'upon initial recognition are designated as at fair value through profit or loss'. The wording seems to indicate that the fair value option is applied on an investment-by-investment basis.

19. We also noted that the Basis for Conclusions of IAS 28 (2003) indicates that the fair value option was introduced as an exemption to the equity method on an investment-by-investment basis. The relevant paragraphs state (emphasis added):

BC8. The Board decided that if venture capital organisations, mutual funds, unit trusts and similar entities are to be excluded from the scope of IAS 28, it should be only when they recognise changes in the fair value of their investments in associates in profit or loss in the period in which those changes occur. This is to achieve the same treatment as for investments in subsidiaries or associates that are not consolidated or accounted for using the equity method because control or significant influence is intended to be temporary. 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.

BC9. The Board noted that if such investments were classified in accordance with IAS 39, they would not always meet the definition of investments classified as held for trading because venture capital organisations may hold an investment for a period of 3-5 years. In accordance with IAS 39 such an investment is classified as available for sale (unless the entity elects to designate the investment on initial recognition at fair value through profit or loss). Classification as available for sale would not result in recognising changes in fair value in profit or loss. To achieve a similar effect on income to that of applying the equity method, *the Board decided to exempt investments held by venture capital organisations, mutual funds, unit trusts and similar entities from this Standard only when they are measured at fair value through profit or loss (either by designation or because they meet the definition in IAS 39 of held for trading).*

***IAS 28 revised in 2011***

20. We analysed how the wording in IAS 28 was revised in 2011. We noted that 'upon initial recognition are designated as at fair value through profit or loss' was deleted and the Basis for Conclusion does not specifically discuss the application of the fair value option. We also noted that no specific discussion was held at the IASB over changing the application of the fair value option from an investment-by-investment basis to a consistent policy basis. In addition, no specific transition requirement was provided in relation to the application of the fair value option. Accordingly, we have not found evidence that the IASB had an explicit intention to change the basis on which an entity applies the fair value option.

### *Analysis of the current Standard*

21. We analysed how the current Standard could be read, as follows.

***Are the equity method, and the fair value option, accounting policy decisions?***

22. We consider that the equity method and the fair value option are different accounting policies, because a change between the equity method and the fair value option results in a change in the measurement basis. A change in the measurement basis applied is a change in an accounting policy, in accordance with paragraph 35 of IAS 8.

***If the fair value option is an accounting policy, should it be applied consistently?***

23. We consider that the wording in the current Standard would be read that the fair value option should be applied consistently, because paragraph 13 of IAS 8 requires consistent application of accounting policies for similar transactions, other events and conditions, unless an IFRS *specifically* requires or permits differently.

***Does IAS 28 specifically require or permit any exception to the consistent application of an accounting policy regarding the application of the fair value option?***

24. We consider that IAS 28 does not *specifically* require or permit the application of the fair value option on an investment-by-investment basis. Accordingly, we consider that the current Standard could be read as meaning that an entity shall

apply the equity method or fair value option consistently, in accordance with paragraph 13 of IAS 8.

25. We note the use of a plural noun ‘investments’ in ‘the entity may elect to measure investment*s* in those associate*s* and joint venture*s* at fair value’. We think this supports the view that the fair value option should be applied consistently.

### *Proposal for an Annual Improvement*

26. On the basis of this analysis, we think that the most common interpretation of the wording of the current Standards will be that consistent application of the fair value option is required, because:

 (a) consistent application of an accounting policy is required, in accordance with paragraph 13 of IAS 8, unless other IFRS *specifically* requires or permits different treatments; and

 (b) paragraph 18 of IAS 28 does not *specifically* require or permit an exception to the consistent application of an accounting policy.

27. We consider that this is an unintended consequence, because IAS 28 (2003) allowed the application of the fair value option in an investment-by-investment basis and the IASB did not specifically discuss changing the accounting treatment when IAS 28 was revised in 2011.

28. We also consider that it would be difficult for issuers that had applied the fair value option on an investment-by-investment basis in accordance with IAS 28 (2003) to change their accounting policy to achieve consistency among their investees, especially without any transition relief.

29. Accordingly, we consider that entities should be *specifically* allowed to apply the fair value option on an investment-by-investment basis.

30. We consulted a several IASB members at a number of meetings to inform them about this issue and to obtain their informal individual views. Those IASB members who expressed a view support allowing the fair value option on an investment-by-investment basis.

31. We recommend that the wording of paragraph 18 of IAS 28 should be amended in an Annual Improvement.

## Assessment against the interpretations agenda criteria

| **Agenda criteria** | |
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| We should address issues (5.16): | |
| that have widespread effect and have, or are expected to have, a material effect on those affected. | **Yes.** The fair value option for an associate or joint venture is widely applied and may have a material effect on those affected. |
| where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods. | **Yes.** We think that it is necessary to amend paragraph 18 of IAS 28, to specify that application of the fair value option is available on an investment-by-investment basis. |
| that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*. | **Yes.** Amendments to IAS 28 can resolve the issue. |
| 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)? | **Yes.** Amendments to IAS 28 can resolve the issue. |
| 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. |
| In addition to the implementation and maintenance criteria, an AIP should (6.11, 6.12): | |
| Replace unclear wording<br><br>Provide missing guidance<br><br>Correct minor unintended consequences, oversights or conflict | **Yes.** The issue is an unintended consequence of the changes to IAS 28 in 2011. |
| Not change an existing principle or propose a new principle | **No.** It does not change an existing principle or propose a new principle. |
| Not be so fundamental that the IASB will have to meet several times to conclude (6.14) | **No.** The issue is mere correction of an unintended consequence, so it will not be so fundamental that the IASB will have to meet several times to conclude. |

### Staff recommendation

32. We recommend that the Interpretations Committee should take the issue onto its agenda in the Annual Improvements project, so that entities should be *specifically* allowed to apply the fair value option on an investment-by-investment basis.

| **Questions for the Interpretations Committee** |
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| 1. Does the Interpretations Committee agree that an entity should be allowed to apply the fair value option on an investment-by-investment basis?<br>2. Does the Interpretations Committee agree with the staff's recommendation that the Interpretation Committee should take this issue onto its agenda as an Annual Improvement? |

## Appendix A—Original agenda request

A1. We received the following submission. All information has been copied without modification, except for details that would identify the submitter of the request.

### Impact of moving the scope exemption in IAS 28 – *Investments in Associates and Joint Ventures* (IAS 28 (2003)) to the body of IAS 28 – *Investments in Associates and Joint Ventures* (IAS 28R).

Please find below an analysis of an issue that is of relevance to the group. The analysis includes background to the issue, an outline of the two possible views in this regard; a technical analysis of our preferred view; an analysis of the results of our research into the diversity of views and practices; and our recommendation. We would appreciate it if the IFRS Interpretations Committee (IFRSIC) could consider this issue for their agenda.

**Background**

We noted that the International Accounting Standards Board (IASB) replaced IAS 28 – *Investments in Associates* (IAS 28 (2003)) in May 2011 with IAS 28 – *Investments in Associates and Joint Ventures* (IAS 28R). More specifically, we noted that the previous scope exemption for investments in associates or a joint venture held by venture capital organisations, or mutual funds, unit trusts and similar entities including investment-linked insurance funds (investments) per IAS 28 (2003), paragraph 1 has been moved to the body of IAS 28R, being paragraph 18 (refer to Annexure A).

Based on the wording in IAS 28 (2003), entities explicitly had an option as to whether it measured such investments using the equity accounting method or designated at fair value through profit or loss in accordance with IAS 39, *Financial Instrument: Recognition and Measurement* (IAS 39). Accordingly, in terms of IAS 28 (2003) entities had the ability to measure (through designation) such investments (on an investment by investment basis) at fair value through profit or loss in terms of IAS 39.

IAS 28R contains a similar requirement, albeit that it is located in the body of the standard as opposed to its scope. As part of the group's IFRS 10 – *Consolidated Financial Statements* (IFRS 10) readiness project, it was discussed whether the above-mentioned change resulted in any change in accounting requirements and, more specifically, the following two views were expressed:

1. No change to IAS 28's (2003) measurement requirements, i.e. an entity may continue to apply the exemption and can elect to designate such investments either to be measured at fair value through profit or loss in terms of IAS 39[1] or to apply equity accounting on an investment by investment basis. In terms of this view, some investments may be designated at fair value and other investments are permitted to be equity accounted; or
2. IAS 28R permits either designation at fair value through profit or loss or equity accounting measurement to such investments through an accounting policy election – i.e. the election is not permitted on an investment by investment basis.

[1] Whilst we refer here to IAS 39, our submission also seeks clarification of the treatment under *IFRS 9 – Financial Instruments*. We have referred to IFRS 9 later in this document.

**Analysis**

Based on an analysis of IAS 28R we believe that the correct view is (1), i.e. that entities still have the ability to elect, on an investment by investment basis, whether to designate the investment to be measured at fair value through profit or loss in terms of IAS 39 or to measure the investment using the equity method in terms of IAS 28R. We believe that this view is supportable through the following analysis:

- IAS28R's bases of conclusion (BC10) notes that IAS 28 (2003)'s scope exception was deleted and replaced with a measurement exemption from measuring investments in associates and joint ventures using the equity method (*'... more appropriately characterised as a measurement exemption, and not as a scope exception'*). The scope exception was removed at the time IFRS 12 - *Disclosure of Interests in Other Entities* (IFRS 12) was issued to ensure that the IFRS 12 disclosure requirements for investments in associates and joint ventures, for which an entity elects to measure at fair value through profit or loss, would still be required. Therefore the ability to designate such investments, on an investment by investment basis, is still applicable since it was the IASB's intention to ensure that IFRS 12 would be applicable to all interests in associates and joint ventures - regardless of measurement basis – as opposed to amending the measurement basis application thereof.
- Paragraph 18 of IAS 28R refers to where an entity has an investment in an associate or joint venture and that an entity may elect to measure investments in those associates or joint ventures through profit or loss in accordance with IFRS 9 - all IFRS 9 references to refer to IAS 39 until IFRS 9 is adopted. We believe that the statement is clear in permitting investments to be designated at fair value through profit or loss on an investment by investment basis. This is because paragraph 18 refers to *'an investment'* (i.e. singular) and then refers to the ability to elect to measure that investment at fair value through profit or loss.
- Paragraph 19 of IAS 28R permits a portion of an investment in an associate or joint venture to be measured at fair value through profit (where held in a venture capital organisation) and another portion of the same investment to be equity accounted where that other portion is not held in a venture capital organisation. This paragraph implies that, for such investments, the entity may *'elect to measure that portion of the investment in the associate at fair value through profit or loss in accordance with IFRS 9 …'* We believe that this supports the view above that designation of such investments at fair value through profit or loss is permitted as otherwise paragraph 19 would be contrary to paragraph 18's requirements (i.e. paragraph 19 could then be applied as an election despite the election in paragraph 18).
- Paragraphs 18 and 19 of IAS 28R both refer to electing to measure the investments at fair value in accordance with IFRS 9. Since the group has not adopted IFRS 9, this reference should be read as IAS 39 in which case IAS 39 provides one with the ability (option) to measure such items, on an investment by investment basis, as at fair value through profit or loss. Further, both IAS 28 (2003) and IAS 28R refer to measuring such investments in terms of IAS 39 and hence the approach to designate investments as at fair value through profit or loss on an investment by investment basis is still appropriate.
- We do not believe that the IASB intended to change the ability to designate such investments at fair value through profit or loss *on an investment by investment basis* to an accounting policy choice (i.e. either fair value or equity accounting measurement) since no specific transitional provisions were provided by IAS 28R. Should it be interpreted that IAS 28R requires an entity to be consistent in terms of the measurement approach for such investments and hence would either require additional investments to be measured at fair value through profit or loss or investments to no longer be measured at fair value through profit or loss (depending on election), then such an

approach would require an amendment to IAS 39 with respect to the designation at fair value through profit or loss requirements. This is because IAS 39's designation at fair value through profit or loss is required to be applied on initial recognition and that reclassifications into or out of this category are not permitted. Such an approach, in the absence of transitional provisions to allow otherwise, would hence not be permissible in terms of IAS 39.

The analysis above has referred to IAS 39. Whilst the group has not adopted *IFRS 9 – Financial Instruments* (IFRS 9) at this time (and is not expecting to early adopt), we would like the IFRSIC to also consider and provide clarity on this issue in terms of the requirements of IFRS 9. IFRS 9's scope notes that IAS 28R permits an entity to account for such investments in terms of IFRS 9. It is noted that IFRS 9 contains a classification and measurement model that includes consideration of an entity's business model for managing the financial assets; permits an entity to irrevocably designate a financial asset to be measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch) that would otherwise arise; and permits an entity to irrevocably measure investments in equity instruments that would otherwise be measured at fair value through profit or loss in other comprehensive income. Despite this, IAS 28R clearly states that, *'…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',* and hence we believe that our views expressed above would continue under IFRS 9, i.e. that an entity may elect, on an investment by investment basis to measure such investments at fair value through profit or loss.

**<u>Diversity in practice</u>**

As part of our research into this item, we contacted and discussed the above-mentioned issue with five financial institutions. The results included the following:

- Three of the five financial institutions (including ourselves) indicated that the above-mentioned issue affects them, i.e. that those entities designate some investments to be measured on a fair value basis and equity account others. One of those financial institutions noted that this is an issue in their off-shore;
- One of the five financial institutions indicated that the abovementioned issue will affect them in the future with respect to new business that they will be entering into; and
- One of the five financial institutions indicated that they only designate such investments to be measured on a fair value basis, noting that they do not agree with our view that investments can be designated to be fair valued on an investment by investment basis.

Our group is required (by law) to be audited by two audit firms. Our auditors had opposing views in this regard. Our research into the other firm's guidance materials did not suggest disagreement with our view (although it was not specifically addressed as part of their guidance).

The above research suggests that there is diversity in practice with respect to the above-mentioned issue.

## Recommendations

We believe that the changes from IAS 28 (2003) to IAS 28R do not change an entity's ability to designate such investments at fair value through profit or loss on an investment by investment basis. It is the our understanding that the amendment was made to ensure that the IFRS 12 disclosure would apply to all investments in associates and joint ventures, regardless of the measurement basis applied. Accordingly, we recommend that the IASB amend IAS 28(R) to provide such clarification as we have noted that audit and consulting firms are interpreting the change differently and further that there is diversity in practice.

Should the IASB regard view (2) above as the appropriate view, then we recommend that IAS 28R be amended to provide such clarification and that transition requirements from IAS 28 (2003) to IAS 28R be provided.

Yours faithfully

**Annexure A**

**<u>IAS 28 – *Investments in Associates* (IAS 28 (2003)</u>**

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.

**<u>IAS 28 – *Investments in Associates and Joint Ventures* (IAS 28R)</u>**

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.