STAFF PAPER

October 2014

IASB Meeting

Project	**Narrow-scope amendments to IFRS 10 *Consolidated Financial Statements***
Paper topic	Investment Entities Amendments—application of the equity method by a non-investment entity investor to an investment entity investee

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Introduction

1. The requirements for investment entities were introduced when *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27) (the ‘Investment Entities Amendments 2012’) was issued in October 2012. The requirements are effective for annual periods beginning on or after 1 January 2014. Earlier application is permitted.

2. Paragraph 33 of IFRS 10 *Consolidated Financial Statements* requires a non-investment entity parent of an investment entity to ‘unwind’ the fair value accounting of its investment entity subsidiaries and consolidate all subsidiaries in the group, whether held directly or indirectly, in accordance with paragraph 33 of IFRS 10 *Consolidated Financial Statements*.

3. IAS 28 was not amended as part of the Investment Entities Amendments 2012. It does not contain an equivalent explicit statement related to the application of the equity method by a non-investment entity. The IFRS Interpretations Committee (the ‘Interpretations Committee’), and subsequently the IASB, were asked whether a non-investment entity must also ‘unwind’ the fair value measurement used for the subsidiaries of its associates and joint ventures that are investment entities.

4. In the Exposure Draft *Investment Entities: Applying the Consolidation Exception*, issued in June 2014 (the '2014 ED'), the IASB proposed to amend IAS 28 to:

   (a) provide relief to a non-investment-entity investor by requiring it to retain, when applying the equity method, the fair value measurement applied by an investment entity associate to its interests in subsidiaries; and

   (b) clarify that a non-investment-entity investor that is a joint venturer in a joint venture that is an investment entity cannot, when applying the equity method, retain the fair value measurement applied by the investment entity joint venture to its interests in subsidiaries (ie the non-investment-entity investor must unwind the fair value measurement).

5. The following extract from the Basis for Conclusions on the 2014 ED explains why the IASB proposed these requirements.

> BC19 The IASB noted that paragraphs 35–36 of IAS 28, which require the use of uniform accounting policies, would apply for an entity and its investment entity associates or joint ventures. For a non-investment entity with interests in investment entity associates and joint ventures, this would mean that the subsidiaries of those investment entity associates and joint ventures should be consolidated into the financial statements of those associates and joint ventures prior to the equity method being applied. The IASB noted that this is conceptually consistent with the requirement in IFRS 10 for a non-investment entity parent to consolidate subsidiaries held through an investment entity subsidiary.
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> BC20 Some Interpretations Committee and IASB members raised concerns about the potentially significant practical difficulty for an entity in unwinding the fair value measurement used by an investment entity associate or a joint venture for their interests in subsidiaries. Although the IASB understood the practical difficulty, some IASB members noted 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 over its joint venture and, consequently, should have the ability to obtain the accounting information needed to adjust the financial statements of the investment entity joint venture to consolidate its subsidiaries in order to apply the equity method, compared with investors that only have significant influence over investment entity associates.

BC21 The IASB also discussed the structuring risks highlighted in paragraph BC280 of IFRS 10 and noted 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. This is because a joint venturer has joint control of its joint venture, whereas an investee has only significant influence over an associate. Consequently, an investor in an associate cannot control the investment (or divestment) decisions of the associate and, therefore, would not be indifferent to structuring its investments through a joint venture instead of through an associate.

BC22 The IASB noted that there are currently no differences in how IAS 28 is applied to an investment in an associate and a joint venture. However, the IASB decided 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, provide a basis for differentiating between an associate and a joint venture when applying the equity method in this particular case.

6. The Appendix reproduces the proposed amendments to IAS 28.

Purpose of this paper

7. Because of the urgency in timing and the limited scope of this and the other issues addressed in the 2014 ED, the IASB set a shortened comment period of 96 days. We are bringing this analysis of responses and staff recommendations to this October meeting because we think that it is important to finalise these issues during this year (2014).

8. The objective of this paper is to:

    (a) present a summary of the responses received on the 2014 ED proposal; and

    (b) provide the staff's analysis of the comments received and the staff's conclusions on the issues raised.

Background information

9. When developing the Investment Entities Amendments 2012, the IASB decided to provide an exception to consolidation because of the unique business model of investment entities. This unique business model makes reporting subsidiaries at fair value more appropriate than consolidation. This exception to consolidation is not available to entities that are not investment entities. [1]

10. As a result, paragraph 33 of IFRS 10 requires a non-investment entity to consolidate all of its subsidiaries, including those controlled through an investment entity subsidiary. Consequently, a non-investment entity must 'unwind' the fair value measurement used by its subsidiaries that are investment entities.

11. Paragraph BC275-BC283 of IFRS 10 explain why the IASB decided to require a non-investment entity to consolidate all of its subsidiaries. The IASB had taken this decision even though the majority of respondents to the Exposure Draft *Investment Entities*, issued in August 2011 (the 'Investment Entities ED') had disagreed with the proposal.

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[1] See paragraph BC226 of IFRS 10.

12. In particular, paragraph BC278 explains:

> 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.

13. Paragraph BC18 of the 2014 ED notes that the scope of the Investment Entities Amendments 2012 was restricted to providing an exception to consolidation for investment entities. As a result,

> [t]he IASB did not intend to change existing practice under IAS 28, because 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, as described in BC283 of IFRS 10. Consequently, it was not considered necessary to amend IAS 28 as a result of issuing the amendments to IFRS 10 that introduced the consolidation exception.

14. Paragraph 18 of IAS 28 permits an investment entity to elect to measure its investments in associates and joint ventures at fair value through profit or loss, instead of using the equity method of accounting.[2]

15. If a non-investment entity has an associate, a portion of which is held indirectly through an investment entity, paragraph 19 of IAS 28 permits the non-investment entity to measure that portion of its investment in the associate at fair value through profit or loss. 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 in this regard.

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[2] Paragraph 18 of IAS 28 refers to an entity 'that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds'. By definition, an investment entity is captured within the types of entities that are permitted to measure their investments at fair value in accordance with this paragraph.

16. The IASB's response to this is set out in paragraph BC283 of IFRS 10, which states:

> 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.

Summary of comments received on the 2014 ED

17. Almost all respondents that commented on this issue agreed with the proposal to amend IAS 28 to provide relief to a non-investment entity investor by requiring it to retain, when applying the equity method, the fair value measurement applied by an investment entity associate to its interests in subsidiaries.

18. A majority of respondents, approximately three-quarters, disagreed with the proposal to amend IAS 28 to clarify that a non-investment entity investor that is a joint venturer in a joint venture that is an investment entity cannot, when applying the equity method, retain the fair value measurement applied by the investment entity joint venture to its interests in subsidiaries.

19. Almost all of the respondents that disagreed with the proposal for joint ventures suggested that the IASB should amend IAS 28 to provide the same relief to a non-investment entity investor, whether its interest is in an associate that is an investment entity or in a joint venture that is an investment entity.

20. A significant minority, more than a fifth, of the respondents who suggested retaining the fair value measurement applied by a joint venture, explicitly stated that they disagreed with paragraph 33 of IFRS 10. They think that a non-investment-entity parent should be able to retain the fair value measurement applied by an investment entity subsidiary. The parent should, therefore, not be

required to consolidate subsidiaries that are controlled indirectly through an investment entity subsidiary.

Reasons given for supporting the proposal to provide relief for interests in investment entity associates

21. Few respondents explained directly their reasoning for supporting the proposal to require a non-investment-entity investor to retain, when applying the equity method, the fair value measurement applied by an investment entity associate to its subsidiaries. However, more than a third of respondents suggested that the cost and practicality issues that the IASB used to support the proposal to provide relief for interests in associates were equally applicable to interests in joint ventures. We think that this provides implicit agreement with the IASB's reasons for proposing the relief on cost and practicality grounds.

22. A small minority of respondents (less than 10 per cent) suggested that the relief should not be applied on a mandatory basis, as the IASB had proposed. Views were mixed as to whether the relief should be available as a free choice, or should only be available if it is impractical to obtain the information necessary to unwind the fair value.

23. The South African Institute of Chartered Accountants (SAICA) incorporated both views in their comment letter.

> Under the current requirements of IAS 28 to align accounting policies, we would support the proposed amendments for equity accounting an investment entity associate due to practical difficulties in obtaining the information, which we understand to be the IASB's rationale. Given that in some instances the information may be available, we believe that there should be a free choice to either retain the fair value measurements or not. Some of our commentators are of the view that if the motivation for the relief is based on the practical difficulty of obtaining the required information, this should be the basis on which IAS 28 requires an investor to apply the equity method. In other words, the standard should contain an

> exemption from aligning the consolidation accounting policies if doing so would be impractical due to the inability of obtaining the information.

24. Some concerns were also raised that mandatory application of the relief could create unintended problems for investors.

    (a) In cases in which the investment entity associate (or joint venture) does not measure its subsidiaries at fair value because it does not apply IFRS, a question was raised about whether the 'relief' may be interpreted as requiring the investor to determine the fair value of its investment entity associate's subsidiaries in order to apply the equity method in the same way for all of its investment entity investees. Consequently, the German Insurance Association (GDV) notes:

    > … we would recommend an explicit clarification (e.g. for Basis for Conclusions on the ED) that the suggested wording for the new paragraphs 36A und 36B does not imply that the fair value measurement must be always applied in the cases discussed, i.e. even when it is not used at the intermediate parent level. In such a case the suggested simplification would not be a relief but could than turn out to be a burdensome requirement. We believe that the requirement to retain the fair value measurement can only apply when the fair value measurement is indeed in place.

    (b) Macquarie Group Limited raised another concern about requiring, instead of permitting, fair value to be retained.

    > … IAS 28 currently provides an entity that is a venture capital organisation, mutual fund, unit trust or similar entities including investment-linked insurance funds with the choice to fair value or equity account investments in associates and joint ventures. A non-investment entity does not have a <u>choice</u> for its direct investments in associates and joint ventures. We consider this Exposure Draft will create a fair value through profit or loss measurement <u>requirement</u> based on the type of investment

(IE or non-IE) rather than consistently focusing on the type of investor.

Reasons given for asking for the same relief for interests in investment entity joint ventures

25. The main reason given for asking the IASB to give the same relief for interests in investment entity joint ventures was the cost and difficulty of obtaining the information needed to unwind the fair value measurement used by the joint venture. As noted in paragraph 21, more than a third of respondents referred to this issue in support of their response.

26. Some of the respondents also disagreed with the structuring concerns that had been noted in paragraph BC21 of the 2014 ED. They highlighted that, although there is a difference between significant influence and joint control, there is a bigger difference between joint control and control. This reasoning was also used to support some of the responses that raised concerns about the cost and practicality of obtaining the consolidation information from joint ventures. For example, the International Organization of Securities Commissions (IOSCO) Committee on Issuer Accounting, Auditing and Disclosure (Committee 1) expressed the following observations, which seem representative of the other comments in this area:

> … Committee 1 members do not believe that the degree of practical difficulty is sufficiently different depending on whether an investee if an associate or joint venture as contemplated by the Board in paragraph BC20 of the Exposure Draft. Similarly, Committee 1 members do not believe it is appropriate to make a distinction in accounting for these similar investments because of the practical difficulty of obtaining the necessary information.
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> In forming its views, the Committee 1 members considered the structuring risks discussed in paragraph BC21 of the Exposure Draft and highlighted in paragraph BC280 of IFRS 10. The members do not believe that these risks are greater for joint ventures than for associates. Specifically,

> Committee 1 members note that joint control infers that one or more third party venture partners must consent to all significant decisions. Therefore, the structuring concern highlighted in paragraph BC280 that may exist in a parent/subsidiary relationship is substantially mitigated by the joint control shared with third parties. …

27. The distinction between control, joint control and significant influence was raised by a significant minority of respondents, approximately one-fifth, who highlighted that the IASB has previously acknowledged that there is a greater distinction between control and joint control than between joint control and significant influence. These respondents suggested that introducing a difference in the way that the equity method is applied to an associate and a joint venture is inconsistent with the IASB's previous decisions, which had been based on the relationship between the investor and investees and the effect of the relationship on the related accounting treatment.

28. In particular, respondents cited paragraph BC41 of IFRS 11 *Joint Arrangements*, which states:

> In relation to the accounting for interests in joint ventures, the Board decided that entities should recognise their interests using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*, unless the entity is exempted from applying the equity method as stated in that standard. In reaching that conclusion, the Board considered the views of some respondents to ED 9 who pointed out that joint control and significant influence are different. Proponents of this view argue that it is not appropriate to account for an associate and a joint venture in the same way using the equity method. Although the Board acknowledged that significant influence and joint control are different, the Board concluded that, except for specific circumstances that are addressed in IAS 28 (as amended in 2011), the equity method is the most appropriate method to account for joint ventures because it is a method that accounts for an

entity's interest in the net assets of an investee. Reconsideration of the equity method was outside the scope of the joint ventures project.

29. There is also a distinction between consolidation and the equity method, which has already been noted in paragraphs 15-16. These paragraphs refer to paragraph 19 of IAS 28. Paragraph 19 of IAS 28 currently permits a non-investment-entity investor to measure at fair value an interest in an associate that is held indirectly through an investment entity. This is inconsistent with the requirement in paragraph 33 of IFRS 10, which requires a non-investment entity parent to unwind the fair value measurement applied to its subsidiaries that are held indirectly through an investment entity. When finalising the Investment Entities Amendments 2012, the IASB accepted this inconsistency for two reasons:

    (a) The scope of the Investment Entities Amendments 2012 was restricted to introducing an exception to consolidation for investment entities. It was not intended to change existing requirements of IAS 28.

    (b) The difference between using the equity method and fair value measurement for investments in associates and joint ventures is smaller than between consolidation and fair value measurement for investments in subsidiaries.

30. An investor does not control the subsidiaries of its associates or joint ventures, unless it obtains control through other routes. Instead, the investor will have significant influence or joint control over the subsidiaries of its associates or joint ventures. Consequently, the investor will recognise its interest in the subsidiaries of its associates and joint ventures by applying the equity method to the associates or joint ventures. As a result, the difference between consolidation and the fair value measurement applied by the investment entity associate or joint venture to its subsidiaries is diluted when the non-investment-entity investor applies the equity method.

31. Other respondents, who did not support a different accounting treatment for interests in associates and joint ventures, highlighted a practical issue relating to paragraph 24 of IAS 28.

> If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.

32. Although we think that the change from associate to joint venture status or vice versa is unlikely to occur frequently, we think that if the IASB decides to finalise the proposal in the 2014 ED for a different accounting treatment between associates and joint ventures, an additional amendment would be needed to IAS 28 to deal with this situation.

Other issues raised by respondents

33. A few respondents noted that requiring a different method of applying the equity method for associates and joint ventures would create a difference with US GAAP. Consequently, they suggested that a non-investment-entity investor should retain the fair value measurement used by both its associates and its joint ventures.

34. A few respondents noted a lack of clarity around the purpose of the equity method, that is, whether it is a measurement basis or a 'one-line consolidation'. This seems to have influenced some views about how the methodology of the equity method should be applied and, consequently, the relevance of the fair value or consolidation information. For example, SAICA noted:

> Currently there is a lack of clarity around whether equity accounting is a type of consolidation or a measurement basis. We are aware that the IASB is planning to start research in this area.[3] We believe that prior to the IASB providing much needed clarity in this area, there should be limited amendments to the equity method of accounting. Without limiting our views on this project, the current tentative view of our commentators is that equity accounting should be a measurement basis, rather than a

[3] http://www.ifrs.org/Current-Projects/IASB-Projects/equity-method-accounting/Pages/equity-method-accounting.aspx

> type of consolidation technique. With this background we would therefore support the proposed amendments for equity accounting an investment entity associate. If equity accounting is a measurement basis, then we would see no basis for a different treatment for investment entity joint ventures.

Staff conclusions

35. The staff are persuaded by the arguments against introducing a different requirement for associates than for joint ventures. We agree with respondents who note that there is a bigger difference between control and joint control than there is between joint control and significant influence. Consequently, it would seem reasonable to conclude that retaining consistency in how the equity method is applied for both associates and joint ventures is important

36. We also acknowledge that, if different accounting is required for interests in associates and interests in joint ventures, then there will be a need to develop additional requirements to amend paragraph 24 of IAS 28 in order to address cases in which a non-investment entity's interest changes from an associate to a joint venture, or vice versa (see paragraph 31).

37. Consequently, we recommend that the IASB should require the same treatment for interests in both associates and joint ventures.

38. We are less clear about whether the IASB should require a non-investment-entity investor to retain or unwind the fair value measurement used by both an investment entity associate and an investment entity joint venture. This is because the arguments for choosing between the alternative requirements are finely balanced.

Unwinding the fair value

39. We consider that requiring the fair value measurement used by the investment entity investee for its subsidiaries to be unwound before applying the equity method of accounting to that investee is the more principle-based solution. We think that it is also the most consistent with the decisions made by the IASB when it introduced the Investment Entities Amendments 2012.

40. This approach is supported by the following points:

    (a) Paragraphs 35-36 of IAS 28 require that an investor should adjust an associate's or joint venture's financial statements in order to apply uniform accounting policies. The application of these uniform accounting policies is based on the nature and accounting policies of the investor.

    (b) The exception to consolidation for investment entities was introduced to reflect the unique business model of an investment entity. A non-investment-entity investor does not have the same unique business model and, therefore, it is inappropriate for a non-investment-entity investor to retain the fair value measurement applied by its investment entity subsidiary.

Retaining the fair value

41. Although we think that unwinding the fair value measurement is the more technically sound solution, we acknowledge the concerns raised by the majority of respondents, who support providing relief to a non-investment-entity investor when applying the equity method to its interests in both associates and joint ventures that are investment entities.

42. This approach is supported by the following points:

    (a) We appreciate that although the practical difficulties of obtaining the consolidation information may be less in a situation of joint control, there may still be significant cost and time constraints. We think that it is unclear that the benefits of requiring the investor to unwind the fair value measurement used in its joint venture's financial statements would outweigh these costs and practical difficulties.

(b) The structuring concern that may exist in a parent/subsidiary relationship is likely to be substantially mitigated by the joint control shared with third parties.

(c) The difference between consolidation and fair value measurement for investments in subsidiaries is diluted when a non-investment-entity investor applies the equity method to its interest in an associate or joint venture that is an investment entity.

Option or requirement to retain fair value

43. We acknowledge that offering a choice to either retain the fair value measurement or unwind it may reduce comparability between entities. However, we think that, if the IASB decides to provide relief to non-investment entity investors, then we consider that it should be available as a choice but not be required or restricted. This is because:

(a) The basis of the proposed relief is the potentially significant practical difficulty and additional costs that may be encountered when unwinding the fair value measurement used by an investment entity associate or a joint venture for their interests in subsidiaries. Preventing a non-investment-entity investor from unwinding the fair value measurement used by its investment entity associates and/or joint ventures when it can obtain the information that it needs to do so would be conceptually inconsistent, for the reasons given in paragraph 39.

(b) Allowing a choice to either retain the fair value measurement or unwind would be more consistent with the existing choice in paragraph 19 of IAS 28. As noted in paragraph 15, if a non-investment entity has an associate, a portion of which is held indirectly through an investment entity, paragraph 19 of IAS 28 permits, but does not require, the non-investment entity to measure that portion of its investment in the associate at fair value through profit or loss. In addition, making the relief available only if it is impractical to obtain the information necessary to unwind the fair value measurement is likely to create tensions between investors and their auditors and securities regulators or other enforcement bodies. This is because there are likely to be differences of opinion as to what constitutes 'impractical'. This approach could also result in an entity unwinding the fair value in some investees for which information is available, but not for others. This could be confusing for users of the financial statements.

(c) As well as having investees that report in accordance with IFRS, a non-investment-entity investor may have investment entity associates or joint ventures that report using different accounting frameworks. Some of these other frameworks may not permit the consolidation exception provided in IFRS 10. Such entities may wish to unwind the fair value measurement applied by its IFRS investees in order to apply a consistent accounting policy across all of their investees.

Staff recommendations

44. We recommend that the IASB should require the same treatment for interests in both associates and joint ventures, for the reasons given in paragraphs 35-36.

45. The arguments for choosing whether the IASB should require a non-investment-entity investor to retain or unwind the fair value measurement used by both an investment entity associate and an investment entity joint venture are finely balanced (see paragraphs 38-42). We ask the IASB to decide which alternative it prefers.

46. If the IASB decide, for the reasons given in paragraph 42, that a non-investment-entity investor should not be required to unwind, when applying the equity method, the fair value measurement applied by an investment entity associate or joint venture to its interests in subsidiaries, we recommend that the relief be available as a choice but not be required or restricted, for the reasons given in paragraph 43.

Questions for the IASB

Questions for the IASB

1. Does the IASB agree with the staff recommendation to require the same treatment for interests in both associates and joint ventures?

2. Does the IASB want to:

    a) Require, for the reasons given in paragraph 40, a non-investment-entity investor to unwind, when applying the equity method, the fair value measurement applied by an investment entity associate or joint venture to its interests in subsidiaries? or

    b) Provide relief, for the reasons given in paragraph 42, to a non-investment-entity investor by enabling the investor to retain, when applying the equity method, the fair value measurement applied by an investment entity associate or joint venture to its interests in subsidiaries?

3. If the IASB decide to provide the relief in response to Question 2(b), does the IASB agree with the staff recommendation to make the relief available as a choice, consistently with the existing relief available in paragraph 19 of IAS 28?

    If not, does the IAS want to make the relief

    (a) mandatory, or

    (b) available only if it is impractical to obtain the information necessary to unwind the fair value measurement?

Appendix: Proposed amendments to paragraphs 31 and 32 of IFRS 10, together with the related application paragraphs B85B-B85E, as published in the 2014 ED.

A1. The 2014 ED proposed to amend paragraph 36 of IAS 28 and add paragraphs 36A-36B. Deleted text is struck through and new text is underlined.

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

36 Except as described in paragraph 36A, ~~I~~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.

36A Notwithstanding the requirement in paragraph 36, if an entity has an interest in an associate that is an investment entity, the entity shall, when applying the equity method, retain the fair value measurement applied by that investment entity associate to its interests in subsidiaries.

36B If the entity is a joint venturer in a joint venture that is an investment entity, the entity shall not, when applying the equity method, retain the fair value measurement applied by that investment entity joint venture to its interests in subsidiaries. Instead, the entity shall, in accordance with paragraph 36, make adjustments to the joint venture's accounting policies to conform to the entity's accounting policies, which shall include the consolidation of all subsidiaries.