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## **Approval by the Board of IAS 28 issued in December 2003**

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International Accounting Standard 28 *Investments in Associates* (as revised in 2003) was approved for issue by the fourteen members of the International Accounting Standards Board.

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Tatsumi Yamada

## Basis for Conclusions on IAS 28 *Investments in Associates*

*This Basis for Conclusions accompanies, but is not part of, IAS 28.*

### Introduction

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- BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 28 *Accounting for Investments in Associates* in 2003. Individual Board members gave greater weight to some factors than to others.
- BC2 In July 2001 the Board announced that, as part of its initial agenda of technical projects, it would undertake a project to improve a number of Standards, including IAS 28. The project was undertaken in the light of queries and criticisms raised in relation to the Standards by securities regulators, professional accountants and other interested parties. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts within Standards, to deal with some convergence issues and to make other improvements. In May 2002 the Board published its proposals in an Exposure Draft of *Improvements to International Accounting Standards*, with a comment deadline of 16 September 2002. The Board received over 160 comment letters on the Exposure Draft.
- BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for investments in associates established by IAS 28, this Basis for Conclusions does not discuss requirements in IAS 28 that the Board has not reconsidered.

### Scope exclusion: investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities

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- BC4 There are no specific requirements that address accounting for investments by venture capital organisations, mutual funds, unit trusts and similar entities. As a result, depending on whether an entity has control, joint control or significant influence over an investee, one of the following Standards is applied:
- (a) IAS 27 *Consolidated and Separate Financial Statements*,
  - (b) IAS 28 *Investments in Associates*, or
  - (c) IAS 31 *Interests in Joint Ventures*.
- BC5 The Board considered whether another approach is appropriate for these investors when they have joint control or significant influence over their investees. The Board noted that use of the equity or proportionate consolidation methods for investments held by venture capital organisations, mutual funds, unit trusts and similar entities often produces information that is not relevant to their management and investors and that fair value measurement produces more relevant information.
- BC6 In addition, the Board noted that there may be frequent changes in the level of ownership in these investments and that financial statements are less useful if there are frequent changes in the method of accounting for an investment.

### Measurement at fair value in accordance with IAS 39

- BC7 Accordingly, the Board decided that investments held by venture capital organisations, mutual funds, unit trusts and similar entities including investment-linked insurance funds should be excluded from the scope of IAS 28 and IAS 31 when they are measured at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. The Board understands that fair value information is often readily available because fair value measurement is a well-established practice in these industries including for investments in entities in the early stages of their development or in non-listed entities.

### Treatment of changes in fair value

- 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).

## Reference to 'well-established' industry practices

- BC10 The Exposure Draft proposed to limit the availability of the scope exclusion to situations in which well-established industry practice existed. Some respondents noted that the development of industry practice to measure such investments at fair value would have been precluded in industries established in countries already applying IFRSs. The Board confirmed that the main purpose of the reference to 'well-established' practice in the Exposure Draft was to emphasise that the exclusion would apply generally to those investments for which fair value is already available.
- BC11 Therefore, the Board decided that the availability of the exclusion should be based only on the nature of an entity's activities and to delete the reference to 'well-established' practices. The Board understands that measurement of these investments at fair value is 'well-established' practice in these industries.

## Definition of 'venture capital organisations'

- BC12 The Board decided not to define further those 'venture capital organisations and similar entities' excluded from the scope of the Standard. Apart from recognising the difficulties of arriving at a universally applicable definition, the Board did not want inadvertently to make it difficult for entities to measure investments at fair value. However, the Board decided to clarify that the reference to 'similar entities' in the scope exclusion includes investment-linked insurance funds.
- BC13 The Board decided, however, that if an investee is a subsidiary in accordance with IAS 27, it should be consolidated. The Board concluded that if an investor controls an investee, the investee is part of a group and part of the structure through which the group operates its business and thus consolidation of the investee is appropriate.

## Application of the equity method

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### Temporary significant influence

- BC14 The Board considered whether to remove the exemption from applying the equity method when significant influence over an associate is intended to be temporary. The Board decided to consider this issue as part of a comprehensive standard dealing with asset disposals. It decided to retain an exemption from applying the equity method when there is evidence that an associate is acquired with the intention to dispose of it within twelve months and that management is actively seeking a buyer. The Board's Exposure Draft ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations* proposes to measure and present assets held for sale in a consistent manner irrespective of whether they are held by an investor in an associate or in a subsidiary.<sup>1</sup>

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<sup>1</sup> In March 2004, the Board issued IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 removes this scope exclusion and now eliminates the exemption from applying the equity method when significant influence over an associate is intended to be temporary. See IFRS 5 Basis for Conclusions for further discussion.

## Severe long-term restrictions impairing ability to transfer funds to the investor

- BC15 The Board decided to remove the exemption from applying the equity method for an associate that previously applied when severe long-term restrictions impaired an associate's ability to transfer funds to the investor. It did so because such circumstances may not preclude the investor's significant influence over the associate. The Board decided that an investor should, when assessing its ability to exercise significant influence over an entity, consider restrictions on the transfer of funds from the associate to the investor. In themselves, such restrictions do not preclude the existence of significant influence.

## Non-coterminous year-ends

- BC16 The Exposure Draft of May 2002 proposed to limit to three months any difference between the reporting dates of the investor and the associate when applying the equity method. Some respondents to that Exposure Draft believed that it could be impracticable for the investor to prepare financial statements as of the same date when the date of the investor's and the associate's financial statements differ by more than three months. The Board noted that a three-month limit operates in several jurisdictions and it was concerned that a longer period, such as six months, would lead to the recognition of stale information. Therefore, it decided to retain the three-month limit.

## Recognition of losses

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- BC17 The previous version of IAS 28 and SIC-20 *Equity Accounting Method—Recognition of Losses* restricted application of the equity method when, in accounting for the investor's share of losses, the carrying amount of the investment is reduced to zero.
- BC18 The Board decided that the base to be reduced to zero should be broader than residual equity interests and should also include other non-equity interests that are in substance part of the net investment in the associate, such as long-term receivables. Therefore, the Board decided to withdraw SIC-20.
- BC19 The Board also noted that if non-equity investments are not included in the base to be reduced to zero, an investor could restructure its investment to fund the majority in non-equity investments to avoid recognising the losses of the associate under the equity method.
- BC20 In widening the base against which losses are to be recognised, the Board also clarified the application of the impairment provisions of IAS 39 to the financial assets that form part of the net investment.

## Loss of significant influence over an associate<sup>2</sup>

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- BC21 In the second phase of the Board's project on business combinations, the Board observed that the loss of control of an entity and the loss of significant influence over an entity are economically similar events; thus they should be accounted for similarly. The loss of significant influence is an economic event that changes the nature of the investment. The Board concluded that the accounting guidance on the loss of control of a subsidiary should be extended to events, transactions or other changes in circumstances in which an investor loses significant influence over an investee. Thus, when an investor loses significant influence over an associate, the investor measures any retained investment at fair value. Any difference between the carrying amount of the associate when significant influence is lost, the disposal proceeds (if any) and the fair value of any retained interest is recognised in profit or loss.

## Scope (2008 amendment)<sup>3</sup>

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- BC22 The Board identified an apparent inconsistency in the disclosure requirements for entities that are eligible and elect to account for investments in associates at fair value in accordance with IAS 39. These investments are excluded from the scope of IAS 28 and entities are therefore not required to make the disclosures that the Standard would otherwise require. However, IAS 32 *Financial Instruments: Presentation* and IFRS 7

<sup>2</sup> This heading and paragraph BC21 were added as a consequence of amendments to IAS 27 *Consolidated and Separate Financial Statements* made as part of the second phase of the business combinations project in 2008.

<sup>3</sup> Paragraphs BC22–BC28 were added as a consequence of amendments to IAS 28 by *Improvements to IFRSs* issued in May 2008.

*Financial Instruments: Disclosures* both require entities that account for investments in associates in accordance with IAS 39 to make the disclosures required by IAS 28 in addition to the disclosures they require.

- BC23 The Board decided to remove this inconsistency by deleting from IAS 32 and IFRS 7 the general requirement to make the IAS 28 disclosures, and instead identifying the specific disclosures that should be made. The Board concluded that the specific disclosures it identified would be relevant because of the significant interest entities hold in such investments. The Board also decided to delete from IAS 32 and IFRS 7 the requirement to make the disclosures in IAS 27 because it duplicates the requirement in IAS 27.

## **Impairment losses (2008 amendment)\***

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- BC24 The Board identified unclear guidance in IAS 28 regarding the extent to which an impairment reversal should be recognised as an adjustment to the carrying amount of an investment in an associate.
- BC25 The Board noted that applying the equity method involves adjusting the investor's share of the impairment loss recognised by the associate on assets such as goodwill or property, plant and equipment to take account of the acquisition date fair values of those assets. The Board proposed in the exposure draft *Improvements to International Financial Reporting Standards* published in October 2007 that an additional impairment recorded by the investor, after applying the equity method, should not be allocated to any asset, including goodwill, that forms part of the carrying amount of the investment. Therefore, such an impairment charge should be reversed in a subsequent period to the extent that the recoverable amount of the investment increases.
- BC26 Some respondents to the exposure draft expressed the view that the proposed amendment was not consistent with IAS 39 (regarding reversal of an impairment loss on an available-for-sale equity instrument), or with IAS 36 *Impairment of Assets*, IAS 27 and the proportionate consolidation method in IAS 31 (regarding the allocation of an impairment loss to goodwill and any reversal of an impairment loss relating to goodwill).
- BC27 In its redeliberations, the Board affirmed its previous decisions but, in response to the comments made, decided to clarify the reasons for the amendments to paragraph 33. The Board decided that an investor should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associate because the investment is the only asset that the investor controls and recognises.
- BC28 The Board also decided that any reversal of this impairment loss should be recognised as an adjustment to the investment in the associate to the extent that the recoverable amount of the investment increases. This requirement is consistent with IAS 36, which permits the reversal of impairment losses for assets other than goodwill. The Board did not propose aligning the requirements for the reversal of an impairment loss with those in IAS 39 relating to equity instruments because an entity recognises an impairment loss on an investment in an associate in accordance with IAS 36, rather than IAS 39.

## Dissenting opinion on amendment issued in 2008

### Dissent of Tatsumi Yamada

- DO1 Mr Yamada voted against one of the amendments to IAS 28 *Investments in Associates* issued in *Improvements to IFRSs* in May 2008.
- DO2 Mr Yamada believes it is inappropriate not to allocate any additional impairment losses to the goodwill and other assets that form part of the carrying amount of the investment in the associate. In his view, because he believes that an investor can identify attributable goodwill when it makes an investment, all impairment losses recognised with respect to the investor's investment in an associate should be allocated to the goodwill and other assets that form part of the carrying amount of the investment.
- DO3 Mr Yamada also believes that all impairment losses allocated to goodwill should not be subsequently reversed. In his view the non-allocation of impairment losses to goodwill as required by the amendment and the subsequent reversal of such impairment losses in substance leads to the recognition of internally generated goodwill. He believes that the amendment to IAS 28 is not consistent with paragraphs 124 and 125 of IAS 36 *Impairment of Assets*, which prohibit the reversal of impairment losses related to goodwill.