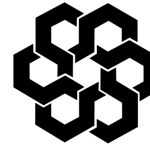

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **November 2008, London**
Project: **Potential effect of IFRS 3 and IAS 27 (as revised in 2008) on equity method accounting (Agenda Paper 7B)**

RELEVANT STANDARDS

- IFRS 3 *Business Combinations* (as revised in 2008)?
- IAS 27 *Consolidated and Separate Financial Statements*
- IAS 28 *Investments in Associates*
- IAS 32 *Financial Instruments: Presentation*
- IAS 39 *Financial Instruments: Recognition and Measurement*

BACKGROUND

1. The IFRIC staff noted that in July 2008 the FASB's Emerging Issues Task Force (EITF) added EITF Issue No. 08-6, "Equity Method Investment Accounting Considerations" (EITF 08-6) to its agenda. EITF 08-6 addresses several potential issues resulting from the recently concluded IASB/FASB joint project on the accounting for business combinations and noncontrolling interests that culminated in the issuance of revised IFRS 3 and IAS 27 and Statement 141(R) and Statement 160, respectively.

2. During the EITF's 10 September 2008 meeting, the EITF discussed Issue No. 08-6 and reached consensus-for-exposure on four issues:
   - How the initial carrying value of an equity method investment should be determined
   - How an impairment assessment of an underlying indefinite-lived intangible asset of an equity method investment should be performed
   - How an equity method investee's issuance of shares should be accounted for
   - How to account for a change in an investment from the equity method to the cost method.

3. At the 24 September 2008 meeting, the FASB Board ratified the four consensuses-for-exposure reached by the EITF and approved the issuance of a draft Abstract for public comment (which closes on 22 October 2008).

4. Included as Appendix 2 to this agenda paper is the Draft Abstract of EITF 08-6 exposed for public comment.

STAFF ANALYSIS

5. The recent amendments to IFRS 3 (revised 2008) and IAS 27 (revised 2008) are effective for annual periods beginning on or after 1 July 2009. In these recent amendments, the Board concluded that a loss of significant influence and a loss of joint control represent significant economic events that require fair value remeasurement.

6. Paragraph BC64 of IAS 27 states:

> BC64 The Board observed that the loss of control of a subsidiary, the loss of significant influence over an associate and the loss of joint control over a jointly controlled entity are economically similar events; thus they should be accounted for similarly. The loss of control as well as the loss of significant influence or joint control represents a significant economic event that changes the nature of an investment. Therefore, the Board concluded that the accounting guidance on the loss of control of a subsidiary should be extended to events or transactions in which an investor loses significant influence over an associate or joint control over a jointly controlled entity. Thus, the investor's investment after significant influence or joint control is lost should be recognised and measured initially at fair value and the amount of any resulting gain or loss should be recognised in profit or loss. Therefore, the Board decided to amend IAS 21 *The Effects of Changes in Foreign Exchange Rates*, IAS 28 and IAS 31, accordingly. The FASB considered whether to address that same issue as part of this project. The FASB concluded that the

accounting for investments that no longer qualify for equity method accounting was outside the scope of the project.

7. Given that this Board notion existed prior to and was re-affirmed by the amendments, the staff does not believe any substantive changes have occurred to the underlying IFRS principles related to the corresponding issues raised by the EITF in its Issue No. 08-6. Additionally, current IFRSs contain guidance on these issues as set out in Appendix 3 to this agenda paper.

STAFF RECOMMENDATION

8. Based on the guidance currently available within IFRSs, the staff recommends not adding an item to the IFRIC agenda to mirror EITF Issue No. 08-6.

QUESTIONS TO THE IFRIC

9. Does the IFRIC agree with the staff recommendation not to add these issues to the agenda?

10. Does the IFRIC have any comments on the wording of the tentative agenda decision (see the Appendix 1 to this agenda paper)?

APPENDIX 1 – TENTATIVE AGENDA DECISION

The IFRIC staff noted that the FASB's Emerging Issues Task Force (EITF) recently added to its agenda, EITF Issue No. 08-6, "Equity Method Investment Accounting Considerations". EITF 08-6 addresses several issues resulting from the recently concluded joint project by the IASB and FASB on accounting for business combinations and accounting and reporting for noncontrolling interests that culminated in the issue of IFRS 3 (revised 2008) and IAS 27 (revised 2008) and FASB Statement 141(R) and Statement 160.

EITF Issue No. 08-6 addresses four issues as follows:

- How the initial carrying value of an equity method investment should be determined
- How an impairment assessment of an underlying indefinite-lived intangible asset of an equity method investment should be performed
- How an equity method investee's issuance of shares should be accounted for
- How to account for a change in an investment from the equity method to the cost method.

The IFRIC noted that in IFRS 3 (revised 2008) and IAS 27 (revised 2008) the Board concluded that the loss of control and the loss of significant influence represent significant economic events that require fair value remeasurement. Other changes in ownership levels that do not result in obtaining or losing control or significant influence should be accounted for in accordance with IAS 28 or IAS 31. These standards do not allow for the remeasurement of the retained ownership interests.

Additionally, the IFRIC noted that current IFRSs contain guidance on these issues that is unaffected by the recent amendments to IFRS 3 and IAS 27.

Given the current guidance in IFRSs, the IFRIC does not expect divergence in practice and [decided] not to add these issues to the agenda.

APPENDIX 2 – DRAFT ABSTRACT OF EITF ISSUE NO. 08-6

EITF ABSTRACTS (DRAFT*)

Issue No. 08-6

Title: Equity Method Investment Accounting Considerations

Dates Discussed: September 10, 2008; [November 13, 2008]

References: FASB Statement No. 141, *Business Combinations*
FASB Statement No. 141 (revised 2007), *Business Combinations*
FASB Statement No. 142, *Goodwill and Other Intangible Assets*
FASB Statement No. 154, *Accounting Changes and Error Corrections*
FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*
AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*
SEC Staff Accounting Bulletin No. 51, *Accounting for Sales of Stock by a Subsidiary*
International Accounting Standard No. 28, *Investments in Associates*

Objective

1. **The objective of this Issue is to clarify how to account for certain transactions involving equity method investments.**

All paragraphs in this Issue have equal authority.
Paragraphs in bold set out the main principles.

* **This draft abstract is being exposed for a public comment period that will end on October 22, 2008.**

Background

2. The FASB and the IASB recently concluded a joint effort in converging the accounting for business combinations as well as the accounting and reporting for noncontrolling interests culminating in the issuance of Statement 141(R) and Statement 160. The objective of that joint effort was not to reconsider the accounting for equity method investments; however, the application of the equity method is affected by the accounting for business combinations and the accounting for consolidated subsidiaries, which were affected by the issuance of Statement 141(R) and Statement 160.

Scope

3. **This Issue applies to all investments accounted for under the equity method.**

Initial Measurement

4. **An entity shall measure its equity method investment initially at cost in accordance with paragraphs D3–D7 of Statement 141(R).**

5. Contingent consideration should only be included in the initial measurement of the equity method investment if it is required to be recognized by specific authoritative guidance.

6. However, if an equity method investment agreement involves a contingent consideration arrangement in which the fair value of the investor's share of the investee's net assets exceeds the investor's initial cost, an amount equal to the lesser of the following shall be recognized as a liability:

a. The maximum amount of contingent consideration not otherwise recognized

b. The excess of the investor's share of the investee's net assets over the initial cost measurement (including contingent consideration otherwise recognized).

7. When a contingency is resolved relating to a liability recognized pursuant to paragraph 6 and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as a liability shall be recognized as an additional cost of the investment. If the amount initially recognized as a liability exceeds the fair value of the consideration issued or issuable, that excess shall reduce the cost of the investment.

Decrease in Investment Value

8. **An equity method investor is required to recognize other-than-temporary impairments of an equity method investment in accordance with paragraph 19(h) of Opinion 18. An equity method investor shall not separately test an investee's underlying indefinite-lived intangible asset(s) for impairment.**

Change in Level of Ownership or Degree of Influence

9. **An equity method investor shall account for a share issuance by an investee as if the investor had sold a proportionate share of its investment. Any gain or loss to the investor resulting from an investee's share issuance shall be recognized in earnings, subject to certain exceptions.**

10. Gain recognition would not be appropriate in situations in which subsequent capital

transactions are contemplated that raise concerns about the likelihood of the investor realizing that gain or in situations in which the investee is a newly-formed, non-operating entity, a research and development entity, a start-up or development stage entity, an entity whose ability to continue in existence is in question, or an entity in another similar circumstance. In those situations, the change in the investor's proportionate share of subsidiary equity shall be accounted for as an equity transaction in consolidation. Subsequent reversal of the amount recognized in equity is prohibited.

Transition

11. This Issue is effective on a prospective basis in fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years. Earlier application by an entity that has previously adopted an alternative accounting policy is not permitted. The transition disclosures in paragraphs 17 and 18 of Statement 154 shall be provided, if applicable.

The provisions of this Issue need not be applied to immaterial items.

APPENDIX 3 – COMPARISON OF EITF ISSUE NO. 08-6 ISSUES WITH CURRENT IFRSs

1. The following staff analysis documents the corresponding IFRS guidance and rationale supporting the staff recommendation. The analysis is arranged in the same order as the issues addressed in EITF Issue No. 08-6.

<u>How the initial carrying value of an equity method investment should be determined</u>

2. Summary of the EITF Consensus-for-Exposure:

> The cost basis of a new equity method investment should be determined using a cost accumulation model which includes transaction costs in the investment and excludes the value of contingent consideration unless it is required to be recognized under other US GAAP literature.

3. The staff notes IFRSs currently have guidance applicable to this issue. Paragraph 11 of IAS 28 states, in part:

> 11 Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition…

4. With respect to transaction costs, the staff believe paragraph 43 and AG67 of IAS 39 (reproduced in paragraph 14 of this Appendix 3) should be used by analogy. Additionally, for other assets not recorded at fair value through profit and loss other standards like IAS 2 and IAS 16 incorporate transaction costs within the initial cost.

<u>How an impairment assessment of an underlying indefinite-lived intangible asset of an equity method investment should be performed</u>

5. Summary of the EITF Consensus-for-Exposure to this issue:

> The entire equity-method investment should be subject to APB Opinion No. 18's other-than-temporary impairment model and a separate impairment assessment of the underlying indefinite-lived intangible assets should not be performed.

6. The staff notes IFRSs currently have guidance applicable to this issue which was added to IAS 28 by *Improvements to IFRSs* in May 2008. IAS 28 states, in part:

> 31 After application of the equity method, including recognising the associate's losses in accordance with paragraph 29, the investor applies the requirements of IAS 39 to determine whether it is necessary to recognise any additional impairment loss with respect to the investor's net investment in the associate.
>
> 32 The investor also applies the requirements of IAS 39 to determine whether any additional impairment loss is recognised with respect to the investor's interest in the associate that does not constitute part of the net investment and the amount of that impairment loss.
>
> 33 Because goodwill that forms part of the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately by applying the requirements for impairment testing goodwill in IAS 36 *Impairment of Assets*. Instead, the entire carrying amount of the investment is tested for impairment in accordance with IAS 36 as a single asset, by comparing its recoverable amount (higher of value in use and fair value less costs to sell) with its carrying amount, whenever application of the requirements in IAS 39 indicates that the investment may be impaired. An impairment loss recognized in those circumstances is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate. Accordingly, any reversal of that impairment loss is recognized in accordance with IAS 36 to the extent that the recoverable amount of the investment subsequently increases. In determining the value in use of the investment, an entity estimates:
>
> (a) …

7. The staff believes that the 2008 amendment to IAS 28 specifically addresses this issue.

<u>How an equity method investee's issuance of shares should be accounted for</u>

8. Summary of the EITF Consensus-for-Exposure to this issue:

> The transaction should be accounted for as if the equity-method investor had sold a proportionate share of its investment with any gain or loss recorded through earnings, subject to certain exceptions.

9. The staff notes IFRSs currently have guidance applicable to this issue. Paragraph 19A of IAS 28 states (relevant section underlined):

> 19A If an investor loses significant influence over an associate, the investor shall account for all amounts recognised in other comprehensive income in relation to that associate on the same basis as would be required if the associate had directly disposed of the related assets or liabilities. Therefore, if a gain or loss previously recognised in other comprehensive income by an associate would be reclassified to profit or loss on the disposal of the related assets or liabilities, the investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when it loses significant influence over the associate. For example, if an associate has available-for-sale financial assets and the investor loses significant influence over the associate, the investor shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to those assets. <u>If an investor's ownership interest in an associate is reduced, but the investment continues to be an associate, the investor shall reclassify to profit or loss only a proportionate amount of the gain or loss previously recognised in other comprehensive income</u>.

10. The relevant section (underlined above) from paragraph 19A of IAS 28 applies to all events that result in an investor's ownership being reduced.

11. The staff notes that while there is no specific guidance on the gain/ loss treatment incurred from a disposal of the underlying ownership interests, this type of disposal would be treated as any other derecognition event in IFRSs.

<u>How to account for a change in an investment from the equity method to the cost method</u>

12. Summary of the EITF Consensus-for-Exposure to this issue:

> The equity-method investor should continue to apply paragraph 19(l) of ABP Opinion No. 18. This means the equity-method investor would be required to recognize a gain or loss on the portion sold, with the remaining investment, at its existing carrying amount, to be accounted for using the guidance in Statement No. 115.

13. The staff notes IFRSs currently have guidance applicable to this issue. IAS 28 states, in part:

> 18 An investor shall discontinue the use of the equity method from the date when it ceases to have significant influence over an associate and shall account for the investment in accordance with IAS 39 from that date,

provided the associate does not become a subsidiary or a joint venture as defined in IAS 31. On the loss of significant influence, the investor shall measure at fair value any investment the investor retains in the former associate. The investor shall recognise in profit or loss any difference between:

(a) the fair value of any retained investment and any proceeds from disposing of the part interest in the associate; and

(b) the carrying amount of the investment at the date when significant influence is lost.

19 When an investment ceases to be an associate and is accounted for in accordance with IAS 39, the fair value of the investment at the date when it ceases to be an associate shall be regarded as its fair value on initial recognition as a financial asset in accordance with IAS 39.

14. Transaction costs, if any, would be accounted for in accordance with IAS 39 as follows:

43 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

…

AG67 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of an available-for-sale financial asset. An asset is acquired for CU100 plus a purchase commission of CU2. Initially, the asset is recognised at CU102. The end of the reporting period occurs one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the asset is measured at CU100 (without regard to the possible commission on sale) and a loss of CU2 is recognised in other comprehensive income. If the available-for-sale financial asset has fixed or determinable payments, the transaction costs are amortised to profit or loss using the effective interest method. If the available-for-sale financial asset does not have fixed or determinable payments, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired.