IFRIC Meeting

Staff Paper

Agenda reference **7**

Date **7 May 2009**

Project **IAS 28 *Investments in Associates***

Topic **Potential effect of IFRS 3 (as revised in 2008) and IAS 27 (as amended in 2008) on equity method accounting**

Introduction

Objective of this paper

1. The objective of this paper is to obtain a decision from the IFRIC on this topic to allow the staff to proceed. As such, this paper:

   (a) provides background information on this issue;

   (b) analyses the alternatives within the context of IFRSs;

   (c) discusses the staff recommendation; and

   (d) asks the IFRIC whether they agree with the staff recommendations.

Background information

2. In November 2008, the IFRIC considered four issues related to the potential effect of IFRS 3 *Business Combinations* (as revised in 2008) (IFRS 3R) and IAS 27 *Consolidated and Separate Financial Statements* (as amended in 2008) on equity method accounting. At that meeting, the IFRIC published a tentative agenda decision not to add two of the issues to its agenda. No comment letters were received on the tentative agenda decision and the IFRIC finalised the decision not to add issues #2 and #4 to its agenda.

3. In November 2008, the IFRIC asked the staff to carry out additional research and analysis on the two additional issues:

   (a) Issue 1 – How the initial carrying value of an equity method investment should be determined; and

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(b) Issue 3 – How an equity method investee's issue of shares should be accounted for.

4. At its March 2009 meeting, the staff updated the IFRIC that a broader review of the potential effect of IFRS 3R was being performed by the staff and would be deliberated by the Board in the future. Issues 1 and 3 were included in this review.

5. Later in March 2009, the work plan for the review of IFRS 3R issues was reconsidered. A post-implementation review of IFRS 3R is already scheduled for 2011. Consequently, most of the IFRS 3R issues reviewed by the staff will be addressed within this post-implementation review. The Board will deliberate only limited issues on this topic in the near term. Additionally, a few issues are being researched by the staff within the context of other current Board projects. (See agenda paper 6 for this meeting for additional information.)

6. The staff notes that Issues 1 and 3 are being included in the staff analysis of the comments received on the exposure draft ED 10 *Consolidated Financial Statements* issued in December 2008. Paragraphs 27-32 and Question 12 of ED 10 specifically request comments on "Accounting for associates and the equity method". Question 12 asks:

> Do you think that the Board should consider the definition of significant influence and the use of the equity method with a view to developing proposals as part of a separate project that might address the concerns raised relating to IAS 28?

7. The comment letter deadline for ED 10 was 20 March 2009. The staff anticipate presenting an analysis of comments for deliberation by the Board at the May 2009 meeting.

Staff analysis

Overview of Staff analysis

8. This agenda paper provides the staff's analysis of Issues 1 and 3 within the context of IFRSs.

Issue 1 – How the initial carrying value of an equity method investment should be determined

9. Paragraph 11 of IAS 28 states, in part:

> 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…

10. The staff notes that "cost" is not a defined term within IAS 28; however, in the staff's opinion, cost is all amounts paid (or payable or liabilities assumed) at the inception of ownership of the investment in the associate. Cost includes all amounts required to be paid to obtain the investment.

11. In the staff's opinion, other IFRSs provide consistent guidance on the treatment of costs. When assets are:

    (a) measured at fair value through profit or loss, the only cost allowed to be capitalised is the fair value of the asset itself with all other costs expensed as incurred; or

    (b) measured on a basis other than fair value through profit or loss (i.e. historical/ unamortized cost, amortized cost, available-for-sale assets, etc), all costs required to obtain the asset are included in the measurement of the asset on initial recognition.

12. With respect to transaction costs to acquire financial assets (not measured at fair value through profit or loss), paragraph 43 and AG67 of IAS 39 *Financial Instruments: Recognition and Measurement* provide guidance:

> 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.

13. Paragraphs 20 and 21 of IAS 40 *Investment Property* state:

> An investment property shall be measured initially at its cost. Transaction costs shall be included in the initial measurement.
>
> The cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Directly attributable expenditure includes, for example, professional fees for legal services, property transfer taxes and other transaction costs.

14. While paragraph 20 of IAS 40 encompasses initial measurement of all investment property and includes the notion that transaction costs are included in the initial measurement, the guidance on fair value measurement after recognition, in paragraph 35 of IAS 40, implicitly requires all transaction costs to be expensed in the first reporting period (consistent with the staff's opinion of the general principle noted earlier in this paper). Conversely, paragraph 36 of IAS 40 providing guidance on the cost model after recognition requires investment properties to be measured in accordance with IAS 16's requirements for that model.

15. Paragraphs 15-22 of IAS 16 provide guidance on the "elements of cost". The guidance in IAS 16 includes expanded guidance, but is consistent with the guidance provided in IAS 40.

16. The guidance in IAS 2 *Inventories* provides guidance on costs (with all measurement models other than the fair value through profit or loss) that is consistent with the standards previously cited. Paragraphs 10 and 11 of IAS 2 state that:

> The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
>
> The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

17. Therefore, in the staff's opinion, <u>the initial carrying value of an equity method investment should be determined</u> consistent with the guidance provided throughout IFRSs for non-fair value through profit or loss measurement models.

This requires all costs paid inclusive of transaction and other costs to be included in the initially recognised cost.

Issue 3 – How an equity method investee's issue of shares should be accounted for

18. Paragraph 19A of IAS 28 was added as consequence of the amendment to IAS 27 in 2008 and states (relevant section underlined):

> 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. 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.

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

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

21. Therefore, in the staff's opinion, if an investor's ownership interest in an associate is reduced through the equity method investee's issuance of shares rather than by the sale of the investor's holdings, the investor would recognise a gain or loss, including the amounts described in paragraph 19A.

22. As a result, in the staff's opinion, the accounting for the equity method investee's issuance of shares should be consistent with the guidance provided in paragraph 19A of IAS 28 and as expanded throughout other IFRSs.

Staff recommendations and questions for the IFRIC

23. As noted previously in this agenda paper, both issues will be included in the staff's analysis of comment letters received on the exposure draft ED 10 *Consolidated Financial Statements*. Therefore, the Board will have the opportunity to deliberate both issues.

24. Proposed wording for the tentative agenda decision is set out in Appendix A.

Staff recommendations on Issue 1 – How the initial carrying value of an equity method investment should be determined

25. The staff believes consistent principles exist in IFRSs that should allow constituents to properly determine the requirements in paragraph 11 of IAS 28. Therefore, given the current guidance in IFRSs, the staff does not expect divergence in practice and the staff recommends not to add this issue to the IFRIC agenda.

26. Additionally, the staff does not believe it is necessary to recommend that the Board consider including this issue in the annual improvements project. However, if the IFRIC does not agree, the staff will present this issue to the Board for their consideration. If the staff were to present this issue to the Board, the staff would recommend adding one (or more) paragraph following paragraph 11 of IAS 28 to provide explicit guidance on the treatment of "costs" consistent with the explicit guidance in other IFRSs (IAS 2, IAS 16, IAS 39, IAS 40, etc).

Issue 1 – Equity method initial carrying value
Does the IFRIC agree with the staff's recommendation not to add this issue to the agenda?
Does the IFRIC recommend that this issue be presented to the Board for potential inclusion within the annual improvements project?
Does the IFRIC have any comments on the wording of the tentative agenda decision?

Staff recommendations on Issue 3 – How an equity method investee's issue of shares should be accounted for

27. The staff believes the guidance in paragraph 19A of IAS 28 and other IFRSs provides consistent principles that should allow constituents to properly determine the treatment of an equity method investee's issuance of shares. Therefore, given the current guidance in IFRSs, the staff does not expect

divergence in practice and the staff recommends not to add this issue to the IFRIC agenda.

28. Additionally, the staff does not believe it is necessary to recommend that the Board consider including this issue in the annual improvements project. However, if the IFRIC does not agree, the staff will present this issue to the Board for their consideration. If the staff were to present this issue to the Board, the staff would recommend the addition of one (or more) paragraph following paragraph 19A of IAS 28 to make explicit the guidance for transactions in which an entity's interest in an associate is increased or decreased, but the entity retains significant influence.

Issue 3 – Equity method investee's issuance of shares
Does the IFRIC agree with the staff's recommendation not to add this issue to the agenda? Does the IFRIC recommend that this issue be presented to the Board for potential inclusion within the annual improvements project? Does the IFRIC have any comments on the proposed wording for the tentative agenda decision?

[Appendix A has been omitted from this Observer note]