Project	***Annual Improvements* Project – 2009-2011 cycle**
Topic	**IAS 28 *Investments in Associates* - Purchases in stages – fair value as deemed cost**

Purpose of this paper

1. The Committee received a question on how to account for changes from available for sale (AFS) category to equity method for an associate purchased by stages.
2. The staff asks the Committee to make a recommendation to the Board to include the issue within the next exposure draft on *Annual Improvements*.

Accounting for change from AFS category to equity method

3. A question has been raised as to how to account for an investment in an associate when the investment was purchased in more than one step. IAS 28 is silent on the accounting for an investment in an associate purchased in stages.
4. The staff has identified that different views on these accounting issues are applied in practice.

Example

5. Entity X purchases an equity investment in Y in three stages:

   (a) Step 1: 5% in January N,

   (b) Step 2: 10% in May N+1, and

   (c) Step 3: 6% on 3 September N+2.

6. In X's IFRS consolidated financial statements, the investment in Y is accounted for as an available for sale (AFS) financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* on steps 1 and 2. Subsequent changes in fair value are items of other comprehensive income (OCI).

7. The staff notes that under IFRS 9 *Financial Instruments*, X may have either, at initial recognition:

   (a) designated the instrument as at fair value through profit or loss (paragraph 4.5 of IFRS 9), or

   (b) irrevocably elected to present in OCI subsequent changes in fair value (paragraph 5.4.4 of IFRS 9) if the instrument is not held for trading, as defined in paragraph 9 of IAS 39.

8. In its analysis below, the staff has taken into account consequences of applying IFRS 9.

9. At step 3, X obtains significant influence over Y on 3 September N+2.

10. Some constituents have highlighted concerns as to what the accounting should be for the investment in Y from the date X obtains significant influence. The questions that arise are:

    (a) Issue 1: at what amount should X recognise its 21% investment in Y at the date it obtains significant influence? and

    (b) Issue 2: how should the accumulated changes in fair value of X's investment in Y from January N to 3 September N+2 be accounted for at the date X obtains significant influence over Y?

Staff analysis

Issue 1: At what amount should the investment in the associate be measured at the date significant influence is obtained?

11. IAS 28 gives guidance for the initial recognition of an associate by an investor in paragraph 11, partly reproduced below:

    > 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.

12. Different views currently exist:

    (a) View A: paragraph 11 of IAS 28 requires the associate to be recognised at cost. The cost to entity X of its investment in Y, when Y becomes an associate, is the sum of consideration paid for each purchase plus a share of Y's profits and other equity movements from the date of each purchase to the date of obtaining significant influence, or

    (b) View B: cost should reflect "cost" at the date X obtains significant influence over Y. The fair value of the pre-existing interest at the date of obtaining significant influence is the "deemed cost" of that portion.

13. The staff notes that view A is consistent with paragraph 11 of IAS 28. Under view A, the measurement basis at initial recognition is the same whether entity X

purchased investment in Y in stages or not. However, the staff believes view A brings about complexity as regards the calculation of goodwill at each stage. Information necessary for measuring goodwill at the date of each purchase may not have been obtained at a time when entity X did not have significant influence over Y.

14. The staff believes that the use of fair value as deemed cost in view B is consistent with the approach taken for step acquisitions in IFRS 3R. Under view B, the calculation of goodwill at the date entity X obtains significant influence is made only at that date, using information available at that date. This overcomes the practical difficulties arising in applying view A.

15. The staff also notes that paragraph 20 of IAS 28 points out similarities between concepts underlying procedures appropriate for the application of the equity method and consolidation procedures as described in IAS 27 *Consolidated and Separate Financial Statements*. The staff thinks asserting such similarities allows for analogising to IFRS 3R for acquisitions achieved in stages.

16. The staff sees merits in both views and acknowledges paragraphs 11 and 20 of IAS 28 may be perceived as providing conflicting guidance.

17. In the staff's opinion, when the investment is classified as AFS prior to X obtaining significant influence over Y, applying view A would lead to unduly onerous goodwill calculations. Therefore, the staff supports view B.

18. The staff believes clarifying that fair value is the "deemed cost" of the investment in Y - previously classified as an AFS - at the date X obtains significant influence over Y would be an improvement that would enhance consistency (similarity to IFRS 3R), simplify financial reporting and reduce diversity in practice.

<u>Issue 2: Accounting for the accumulated changes in fair value in OCI when significant influence is obtained</u>

19. Some constituents question how the accumulated changes in fair value should be accounted for from the date X obtains significant influence over Y when the investment in Y was classified as AFS prior to X obtaining significant influence over Y.

20. The staff believes the fact pattern above is economically similar to a disposal of an AFS followed by the purchase of an investment in an associate. Therefore when the investment becomes an associate and ceases to be an AFS investment, the staff does not see a basis for retaining the AFS fair value in accumulated OCI. The OCI component representing the accumulated changes in fair value of the AFS investment in Y should then be reclassified to profit or loss at the date X obtains significant influence over Y. This is similar to the accounting for the accumulated OCI components when obtaining control of a subsidiary in stages.

21. However, the staff is aware that some are of the view that step 3 is a reclassification from an AFS investment to an investment in an associate and that it should not affect profit or loss for the period.

22. The staff doesn't support this approach and does not see a rationale for continuing to report an AFS component in OCI that is no longer attached to an AFS instrument. In addition, this would give rise to reporting difficulties in practice: the OCI component would have to be closely monitored to remain linked to the investment in associate Y with a view to reclassify to profit or loss it in the event of a sale or an impairment of the investment.

23. If an entity applies IFRS 9, it may have irrevocably elected to present in OCI subsequent changes in the fair value of the investment. Paragraph B5.12 of the Application Guidance of IFRS 9 states that accumulated amounts presented in OCI should not be subsequently transferred to profit or loss. The cumulative gain or loss may be transferred within equity. The staff believes that in this case the

OCI component should be reclassified to retained earnings on the date the entity obtains significant influence over the investee.

Staff recommendation

24. The staff recommends that the fair value of an investment classified as AFS prior to the investor obtaining significant influence over that investment should be the deemed cost of that pre-existing interest at the date the investor obtains significant influence over the associate. The accumulated changes in fair value accounted for in OCI should be reclassified to profit or loss at that date.

25. When accounting is in accordance with IFRS 9 and the entity elected for the presentation in OCI of subsequent changes in fair value, then the accumulated changes in fair value in OCI should be reclassified to retained earnings at the date the investor obtains significant influence over the associate.

26. Because it clarifies the existing requirements in IAS 28 and it increases consistency with IFRS 3R, the staff believes such an amendment is an improvement.

27. Therefore the staff suggests that the Committee recommends that the Board include this clarification of IAS 28 within the *Annual Improvements* project.

28. The staff notes that IAS 28 is to be modified in the short term with substantial consequential amendments from the *Joint Arrangements* standard. The modified IAS 28 should be published before the *Improvements to IFRSs* exposure draft. Therefore, if the Committee agrees with the staff recommendation, the staff will draft wording for the proposed change to that standard at a later date.

Transition requirements

29. The staff believes relief should be provided for existing IFRS preparers when applying this clarification because it believes that requiring full retrospective application would be unduly onerous. Therefore the staff proposes that transition be prospective from the start of the earliest period presented. An entity with an investment classified as AFS that became an associate in stages prior to this amendment should:

    (a) retain the accounting for the investment in the associate that it applied previously; and

    (b) reclassify to retained earnings at the start of the earliest comparative period presented any remaining OCI balance related to the AFS accounting.

Questions to the Committee

Question 1 – Fair value as deemed cost
Does the Committee agree to require that the fair value of an AFS investment that becomes an associate in stages be the deemed cost of that investment at the date the investor obtains significant influence?

Question 2 – Accumulated changes to fair value
Does the Committee agree that the accumulated changes to fair value previously recognised in OCI in accordance with IAS 39 be reclassified to profit or loss at the date the investor obtains significant influence? Does the Committee agree that for investments accounted for in accordance with IFRS 9 with subsequent changes in fair value to OCI, the OCI component be transferred to retained earnings at the date the investor obtains significant influence?

Question 3 – Transition requirements
Does the Committee agree with the proposed transition requirements for this amendment in paragraph 29?

Question 4 – Inclusion in Annual Improvements
Does the Committee agree this issue should be included in the *Annual Improvements* project?