STAFF PAPER

January 2013

IFRS Interpretations Committee Meeting

Project	**IAS 28 *Investments in Associates and Joint Ventures*/IFRS 3 *Business Combinations***
Paper topic	Acquisition of an interest in an associate or joint venture under common control

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Introduction

1. In October 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request seeking clarification of the accounting for an acquisition of an interest in an associate or joint venture from an entity under common control.

2. The submitter's question is whether it is appropriate to apply the scope exemption for business combinations under common control, set out in IFRS 3 *Business Combinations*, by analogy to the acquisition of an interest in an associate or joint venture under common control.

3. This paper is organised as follows:

   (a) Summary of the issue

   (b) Summary of comments received from outreach to the International Forum of Accounting Standard-Setters (IFASS) and securities regulators

   (c) Staff analysis

   (d) Assessment of the issue against the Interpretations Committee's agenda criteria

(e) Staff recommendation not to add this issue to the Interpretations Committee's agenda

(f) Appendix A—Proposed wording for tentative agenda decision

(g) Appendix B—Submission.

Summary of the issue

4. The submitter is concerned with diversity in practice in the accounting of the acquisition of an interest in an associate or joint venture under common control. The submitter observes two approaches in that accounting:

   (a) Approach A: apply paragraph 32 of IAS 28 *Investments in Associates and Joint Ventures* to the acquisition of an interest in an associate or joint venture under common control. Under this approach, on acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for either as goodwill if positive (included in the carrying amount of the investment) or as gain if negative. That paragraph states:

   > An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities is accounted for as follows:
   >
   > (a) Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment. Amortisation of that goodwill is not permitted.
   >
   > (b) Any excess of the entity's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the entity's share of the associate or joint venture's profit or loss in the period in which the investment is acquired.
   >
   > Appropriate adjustments (…).

   (b) Approach B: apply paragraph 2(c) of IFRS 3 that includes a scope exemption for business combinations under common control, by analogy, to the acquisition of an interest in an associate or joint venture under common control. This approach is supported by paragraph 26 of IAS 28.

Paragraph 2(c) of IFRS 3 states (emphasis added):

This IFRS applies to a transaction or other event that meets the definition of a business combination. **This IFRS does not apply to**:

(a) the formation of a joint venture.

(b) the acquisition of an asset or a group of assets that does not constitute a *business*. (…)

(c) **a combination of entities or businesses under common control** (paragraphs B1–B4 provide related application guidance).

Paragraph 26 of IAS 28 states:

Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

5. If an entity applies Approach B, the entity will account for the acquisition of an interest in an associate or joint venture under common control as if it were a business combination under common control. In this case, because specific guidance to account for business combinations under common control is absent from IFRS 3, entities argue that they can consider a hierarchy of guidance when there is no specific IFRS that applies to a particular transaction in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (relevant paragraphs are extracted in the staff analysis of this agenda paper).

6. We note that the submitter is not requesting a clarification of what an appropriate accounting for business combinations under common control is and, therefore, that is **not** the scope of this agenda paper. We also note that, in September 2011, the Interpretations Committee rejected the issue on business combinations under

common control because the accounting is too broad to be addressed through an interpretation or through an annual improvement[1].

Summary of comments received from outreach

7. Specifically, we asked:

Q1. Is the acquisition of an interest in an associate or joint venture from a party under common control common or relevant in your jurisdiction?

Q2. If yes to Q1, what is the prevalent approach in your jurisdiction to account for the acquisition, and why? If you see diversity in practice in that accounting, please explain how the accounting is diversified.

8. We received 17 responses on these questions, of which a summary is provided below.

(a) Seven respondents answered that the acquisition of an interest in an associate or joint venture under common control is not common or relevant to their jurisdictions, whereas nine respondents observe such transactions in practice. One respondent did not refer to whether the transaction is common in its jurisdiction.

(b) Accounting for the acquisition of an interest in an associate or joint venture under common control varies by jurisdictions where such transactions occur in practice.

(c) Some apply paragraph 32 of IAS 28 and recognise any difference between the cost of the investment and the entity's share of the net fair value of the investee's identifiable assets and liabilities either as goodwill or as gain.

(d) However, others apply the IFRS 3 scope exemption by analogy. If the IFRS 3 scope exemption is applied, in many cases, the acquisition of an

[1] See IFRIC Update for September 2011 (http://media.ifrs.org/IFRICUpdateSept11.html#5) : IFRS 3 *Business Combinations*—business combinations involving newly formed entities: factors affecting the identification of the acquirer

interest in an associate or joint venture under common control is accounted for at its carrying values.

(e) A few respondents answered that entities are permitted to choose either the application of paragraph 32 of IAS 28 or application of the IFRS 3 scope exemption by analogy as an accounting policy.

(f) Some respondents suggested that, because of diversity in practice, the Interpretations Committee or IASB should clarify how to account for the acquisition of an interest in an associate or joint venture under common control. Others suggested that the issue should be resolved as part of the IASB's common control project.

Staff analysis

9. We have compared two views below in accounting for the acquisition of an interest in an associate or joint venture under common control.

View A: Application of paragraph 32 of IAS 28

11. Paragraph 32 of IAS 28 provides guidance for the purchase of an interest in an associate or joint venture. It states that, on acquisition of the investment, any difference between the cost of the investment and the investor's share of the net fair value of the investee's identifiable assets and liabilities is accounted for either as goodwill or as gain.

12. In addition, IAS 28 does not set out any scope exemption for transactions under common control.

13. Consequently, proponents of this view think that the acquisition of an interest in an associate or joint venture under common control should be accounted for in accordance with paragraph 32 of IAS 28.

View B: Application of the scope exemption for business combinations under common control by analogy

14. According to proponents of this view, paragraph 26 of IAS 28 indicates that the concepts of accounting for the acquisition of a subsidiary apply when acquiring an interest in an associate or joint venture. In other words, any subsidiary-related principles could be applied with appropriate modifications to the acquisition of an interest in an associate or joint venture.

15. Proponents of this view think that, because the principles set out in IFRS 3 include a scope exemption for business combinations under common control, entities could apply the scope exemption by analogy to an acquisition of an interest in an associate or joint venture under common control.

Staff analysis

18. Paragraphs 10 to 12 of IAS 8 provides a hierarchy of guidance when there is no specific IFRS that applies to a particular transaction:

> 10 In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:
>
> (a) relevant to the economic decision-making needs of users; and
>
> (b) reliable, in that the financial statements:
>
> (i) represent faithfully the financial position, financial performance and cash flows of the entity;
>
> (ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;
>
> (iii) are neutral, ie free from bias;
>
> (iv) are prudent; and
>
> (v) are complete in all material respects.
>
> 11 In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:
>
> (a) the requirements in IFRSs dealing with similar and related issues; and
>
> (b) the definitions, recognition criteria measurement concepts for assets, liabilities, income and expenses in the *Framework*.
>
> 12 In making the judgement described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting

standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11.

19. As discussed above, business combinations under common control are excluded from the scope of IFRS 3 and there is no other IFRS or interpretation providing specific guidance on the accounting for those transactions. Accordingly, in accordance with the hierarchy of guidance in IAS 8, entities may consider the pronouncements of other standard-setting bodies and other accounting literature to find guidance on the accounting for business combinations under common control.

20. On the other hand, IAS 28 does not include a scope exemption for the acquisition of an interest in an associate or joint venture under common control. Paragraph 32 of IAS 28 clearly requires an investor, on acquisition of the investment, to recognise any difference between the cost of the investment and the investor's share of the net fair value of the investee's identifiable assets and liabilities either as goodwill or as gain.

21. In addition, paragraph 32 of IAS 28 does not distinguish between acquisition of an investment under common control and acquisition of an investment from an entity that is not under common control.

22. We note that paragraph 10 of IAS 8 requires management to use its judgement in developing and applying an accounting policy **in the absence of** an IFRS that specifically applies to a transaction.

23. We acknowledge that paragraph 26 of IAS 28 states that many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10 *Consolidated Financial Statements*. For example, paragraph B88 of IFRS 10 states that an entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary. IAS 28 requires that, under the equity method, an investor's share of an investee's profit or loss is recognised in the investor's profit or loss and the investor's share of the investee's other comprehensive income is recognised in the investor's other comprehensive income from the date it obtains significant

influence until the date when its investment ceases to be an associate or a joint venture.

24. We also acknowledge that paragraph 26 of IAS 28 further states that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture. For example, paragraph 18 of IFRS 3 requires that an acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. As discussed above, paragraph 32 of IAS 28 requires recognition of an investment at its fair value on acquisition of the investment.

25. We note that paragraph 26 of IAS 28 refers to the **procedures** or the concepts underlying the **procedures**, as opposed to the **scope** of IAS 28 and IFRS 3. We think that an entity shall first determine whether a transaction is within the scope of IAS 28 or IFRS 3 (ie whether the transaction is a business combination or acquisition of an interest in an associate or joint venture). The entity then considers accounting procedures that particularly apply to the transaction in that specific Standard. In other words, the scope between Standards and the accounting procedures to be applied in a specific Standard should not be confused.

26. In our view, applying another Standard (ie IFRS 3) by analogy when there is a specific guidance in the primary Standard (ie IAS 28) would result in a stretched interpretation of the hierarchy of guidance in IAS 8.

27. Moreover, permitting the application of the scope exemption of IFRS 3 to a transaction that is clearly within the scope of IAS 28 would allow entities to develop a diversified accounting policy following the requirements of IAS 8.

28. Consequently, we think that:

    (a) IAS 28 has clear guidance on the acquisition of an interest in an associate or joint venture, regardless of whether or not the transaction is under common control;

    (b) IAS 8 is clear that application of other IFRS by analogy is permitted only when the primary IFRS to a specific transaction does not provide guidance; and

(c) it is not therefore appropriate to apply the scope exemption for business combinations under common control by analogy to the acquisition of an interest in an associate or joint venture under common control.

Agenda criteria

29. In this section, we assess the submission against the agenda criteria of the Interpretations Committee as follows:

(a) *The issue is widespread and has practical relevance.*

Yes. On the basis of our outreach, we understand that the issue is widespread.

(b) *The issue indicates that there are significant divergent interpretations (either emerging or existing in practice).*

Yes. On the basis of our outreach, we understand that diversity in practice exists.

(c) *Financial reporting would be improved through the elimination of the diverse reporting methods.*

Yes. In our view, diversity has developed in practice because of a stretched interpretation of the hierarchy of guidance in IAS 8. We think that both IAS 28 and IAS 8 are sufficiently clear and, therefore, an interpretation or an amendment to IFRSs is not necessary. Instead, the Interpretation Committee's conclusions in the form of a tentative agenda decision would be useful in improving the financial reporting.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework, and the demands of the interpretation process.*

We think that this criterion is not applicable because the Standards are sufficiently clear.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Yes, because the Standards are sufficiently clear.

(f) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*

Not applicable. At its May 2012 meeting, the IASB supported adding a project on the 'business combinations under common control' as one of the priority research projects as part of the IASB's future agenda. However, no specific project is planned for the acquisition of an interest in an associate or joint venture under common control.

Staff recommendation

30. In our view, diversity has developed in practice because of a stretched interpretation of the hierarchy of guidance in IAS 8. As we have analysed in this agenda paper, we think that both IAS 28 and IAS 8 are sufficiently clear and, therefore, an interpretation or an amendment to IFRSs is not necessary.

31. Consequently, we recommend to the Interpretations Committee that it should not add this issue to its agenda and should issue a tentative agenda decision. Proposed wording for the tentative agenda decision is in Appendix A of this agenda paper.

Question for the Interpretations Committee

Question for the Interpretations Committee
Does the Interpretations Committee agree with the staff recommendation and the proposed wording for the tentative agenda decision?

Appendix A—Proposed wording for tentative agenda decision

IAS 28 *Investments in Associates and Joint Ventures,* IFRS 3 *Business Combinations*

In October 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request seeking clarification of the accounting for an acquisition of an interest in an associate or joint venture from an entity under common control. The submitter’s question is whether it is appropriate to apply the scope exemption for business combinations under common control, set out in IFRS 3 *Business Combinations*, by analogy to the acquisition of an interest in an associate or joint venture under common control.

The Interpretations Committee observed that paragraph 32 of IAS 28 *Investments in Associates and Joint Ventures* has guidance on the acquisition of an interest in an associate or joint venture and does not distinguish between acquisition of an investment under common control and acquisition of an investment from an entity that is not under common control.

The Interpretations Committee also observed that paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires management to use its judgement in developing and applying an accounting policy in the absence of an IFRS that specifically applies to a transaction.

Consequently, the Interpretations Committee noted that it is not appropriate to apply the scope exemption for business combinations under common control by analogy to the acquisition of an interest in an associate or joint venture under common control.

On the basis of the analysis above, the Interpretations Committee determined that, in the light of the existing IFRS requirements, an interpretation or an amendment to IFRSs was not necessary and consequently [decided] not to take this issue onto its agenda. As a result of this, the Interpretations Committee does not expect diversity in practice to continue.

Appendix B—Submission

All information has been copied without modification, but the submitter has been rendered anonymous.

<u>The issue</u>

IAS 28 does not include a scope exemption for accounting for the acquisition of an interest in an associate or a joint venture from a party under common control. An entity may acquire an interest in an associate or a joint venture from another entity and both the acquirer and the vendor are controlled by the same party or parties both before and after the transaction.

IFRS 3.2(c) includes a scope exemption for business combinations between parties under common control. Two approaches for accounting for common control business combinations have developed that have broad support as acceptable in the financial reporting community. In practice, the first is seldom applied and the majority of business combinations under common control are accounted for under the predecessor approach described below.

These approaches are:

a) applying the principles of IFRS 3; or

b) recording the acquired assets and liabilities at predecessor carrying values (hereinafter referred to as ‘ the predecessor method’). In this approach, the assets and liabilities are not restated to their fair values and no goodwill is recognised. The difference between the consideration paid and aggregate book value of the acquiree’s assets and liabilities is usually reflected in a component of equity such as retained earnings or a separate reserve.

IAS 28 requires that on initial recognition the interest in an associate or a joint venture is recognised at cost. Any difference between the cost of the investment and the investor’s share of the net fair value of the investee’s identifiable assets and liabilities is accounted for as either goodwill which is included in the carrying value of the investment or as a gain in the income statement (hereinafter referred to as ‘ the IAS 28 approach’). The absence of a scope exemption would seem to indicate that this approach should be applied to the acquisition of an interest in an associate or a joint venture from a party under common control.

Some have asserted that application of the IAS 28 approach may not be appropriate in common control transactions where consideration may not be the fair value of what is acquired (see Appendix A for an illustration). IAS 28.26 indicates that the principles underlying the procedures used in accounting for the acquisition of a subsidiary are used in accounting for the acquisition of an associate or a joint venture. This provision is referenced as support for applying the business combination scope exemption by analogy in the guidance published by at least two of the major accounting firms (see Appendix B)

Significant diversity in accounting for the acquisition of an interest in an associate from a party under common control seems to have arisen. Some entities account for these transactions using the IAS 28 approach while others apply the predecessor method relying on an analogy to the scope exemption in IFRS 3. This diversity reduces the comparability of financial statements.

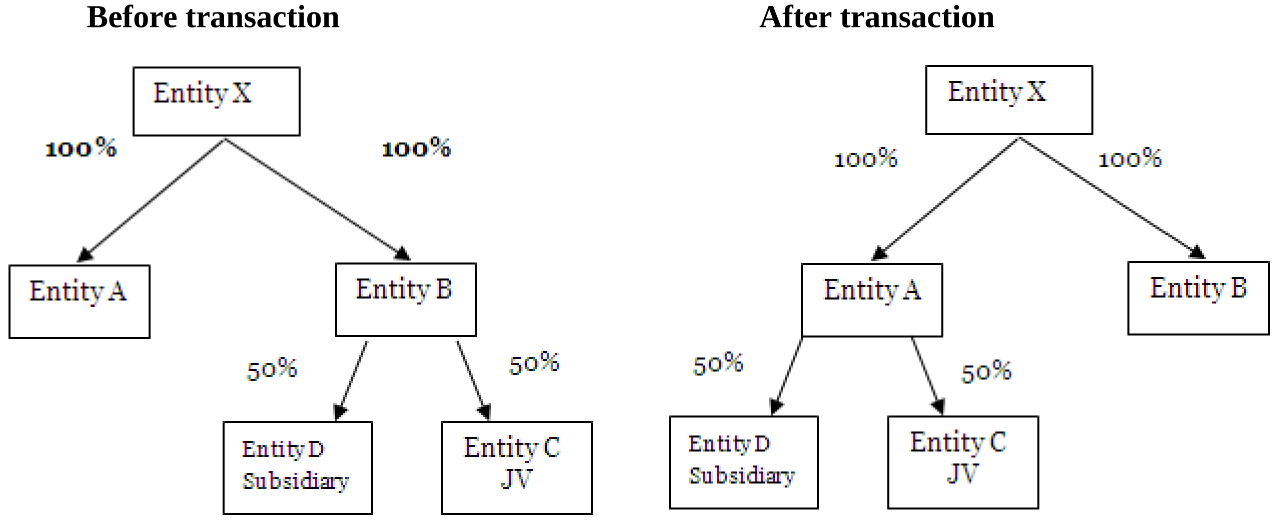
Question:

Is it appropriate to apply the scope exemption for business combinations under common control by analogy to the acquisition of an interest in an associate or a joint venture under common control? Application of the scope exemption would allow entities to develop an appropriate policy following the requirements of IAS 8.

Criteria	**Assessment**
Is the issue widespread and practical?	Yes. The issue affects all entities that acquire associates under common control transactions.
Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?	Yes. There is existing diversity in practice.
Would financial reporting be improved through elimination of the diversity?	Yes.
Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?	Yes. The issue relates specifically to acquisition of associates under common control transactions. We however, acknowledge that there are broader issues around accounting for common control transactions.
If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?	Not applicable.

Appendix A

Applying the IAS 28 approach in a common control transaction



Entity X has two wholly owned subsidiaries A and B. B has 50% interest in C (a joint venture) and D (a subsidiary). The remaining 50% interest in C and D is held by third parties (not related to X, A or B).

Both A and B are required to prepare and publish IFRS financial statements as does Entity X.

The carrying value of C and D in B's consolidated financial statements is CU 1,500 each. The net fair value of identifiable assets and liabilities of C and D (equalling the fair value of these investments) is CU 2, 500 each.

Entity B sells C and D to Entity A at carrying value and Entity A settles this by way of cash payment. The third party investors in C and D remain the same before and after the transaction.

As Entity B has control over Entity D, the transfer is a business combination under common control. Two approaches have developed in practice to account for these transactions. A will either record D as per IFRS 3 at fair value of CU2,500 generating a gain of CU1,000 or follow the predecessor method i.e. at the carrying value of CU 1,500 with no goodwill being recorded. In practice most would choose the predecessor method.

Entity C is a joint venture and not a subsidiary. Entity A applies the IAS 28 approach. C is initially recognised at cost i.e. at CU 1,500 and then a gain of CU 1,000 (being the difference between the cost of investment and A's share of net fair value of identifiable assets and liabilities of C) will be recorded by Entity A. The substance of the transaction is the same (re-organisation of the group) but the accounting treatment could vary significantly.

Further, had Entity X transferred Entity B, C and D to Entity A instead of transferring only C and D, the common control exemption would have applied (because A would obtain control over B which is a business). Entity A would then record the transaction at predecessor values including Entity C which is a joint venture.

This illustrates that with a non-substantive change in the fact pattern, the accounting results could vary significantly.

Appendix B

Summary of guidance included in the Ernst and Young manual

There are two approaches that can be applied for such transactions:

Preferred approach

IAS 28 does not exempt transactions that between entities under common control. Furthermore, the IFRS 3 exemption is clearly for business combinations involving entities under common control – the acquisition of an associate is not a business combination. Therefore, IAS 28 applies as it would to any other acquisition of an associate and the common control exemption given in IFRS 3 cannot be applied.

Acceptable alternative approach

While IAS 28 does not specifically scope out transactions of this nature between entities under common control, the economic substance of these transactions must be considered. Additionally, paragraph 20 of IAS 28 indicates that the concepts of accounting for the acquisition of a subsidiary apply when acquiring an associate. This means that IFRS 3 cannot be applied 'literally' – otherwise none of its subsidiary-related principles could be applied to associates. Instead, the underlying principles must be established and applied with appropriate modifications to the equity method. As these principles include exempting acquisitions of subsidiaries or business between entities under common control, this option should also be available for the acquisition of an associate.

On this basis, the IFRS 3 scope exemption for business combinations among entities under common control can be extended to transactions involving associates.

However, this alternative may only be adopted where equity accounting is seen by management as a form of consolidation rather than a valuation technique in aspects where IAS 28 is silent or ambiguous. This view must be applied consistently to such areas, for example, profit elimination on downstream transactions.

Summary of guidance included in the KPMG manual

In general IFRSs do not make specific provision for the accounting for common control transactions in the separate financial statements when the entity elects to account for investments in subsidiaries at cost in accordance with IAS 27. The only exception is the establishment of a new parent in certain circumstances. In our view, an entity may apply the common control scope exclusion in IFRS 3 by analogy to the accounting for common control transactions in separate financial statements. When the entity elects to account for investments in subsidiaries in accordance with IAS 39, the common control exemption is not relevant and the requirements of IAS 39 apply.

In our view, the common control exemption in accounting for business combinations also applies to the transfer of investments in associates and jointly controlled entities between investors under common control. Although neither IAS 28 nor IAS 31 includes an explicit exemption for common control transactions, both equity accounting and proportionate consolidation follow the methodology of acquisition accounting. Therefore, we believe that it is appropriate to extend the application of the common control exemption.