STAFF PAPER

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IASB Meeting

Project	**IFRS 11 *Joint Arrangements***
Paper topic	Remeasurement of previously held interests—Acquisition of control over a joint operation

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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') discussed whether previously held interests in the assets and liabilities of a joint operation should be remeasured to fair value when the acquisition of an additional interest results in an investor obtaining control over the former joint operation.

2. The Interpretations Committee concluded that previously held interests should be remeasured when control is obtained over a former joint operation that meets the definition of a business. However, it acknowledged that there is a lack of clarity in the wording in paragraphs 41 and 42 of IFRS 3 *Business Combinations*, which has led to diversity in practice. Consequently, the Interpretations Committee has recommended an amendment to IFRS 3 in the form of an annual improvement.

Purpose of this paper

3. The purpose of this paper is to:

   (a) present background information on the issue;

   (b) provide a summary of the staff's analysis and the Interpretations Committee's discussions;

   (c) provide an assessment against the criteria for an annual improvement; and

(d) ask the IASB whether it agrees with the recommendation of the Interpretations Committee.

4. Appendix A provides a draft of the proposed amendment to IFRS 3. This has been included for information purposes only and the IASB will not be asked to provide comments on the wording at the meeting. Editorial comments on the draft wording, if any, should be sent to the staff outside of the meeting.

Background

5. An investor may have joint control of a joint operation that constitutes a business as defined in IFRS 3. Paragraph 20 of IFRS 11 *Joint Arrangements* requires that a joint operator must recognise in relation to its interest in a joint operation, among other things:

(a) its assets, including its share of any assets held jointly; and

(b) its liabilities, including its share of any liabilities incurred jointly.

6. Consequently, the question arises of how to account for this previously held interest in the joint operation if the joint operator obtains control over the business of the joint operation.

7. An entity could also participate in, but not have joint control of, a joint operation. If the party has rights to the assets and obligations for the liabilities, it would also account for its arrangement in accordance with paragraphs 20–22 of IFRS 11 (hereafter referred to as 'party to a joint operation'). Accordingly, a similar question arises if such an entity obtains control over the business of that joint operation.

8. Our outreach confirmed that the transaction is widespread. We understand from our outreach that there are three divergent views that are developing in practice:

(a) View 1—the entity's previously held interest is remeasured;

(b) View 2—the entity's previously held interest is not remeasured; and

(c) View 3—the entity's previously held interest is remeasured if the joint operation is structured through a separate legal entity.

9. Paragraphs 41–42 of IFRS 3 give specific guidance on the accounting for business combinations, if control is acquired in more than one transaction. In particular, for business combinations achieved in stages, paragraphs 41–42 of IFRS 3 require that:

    (a) a previously held equity interest in the acquiree is remeasured to its acquisition-date fair value; and

    (b) any resulting gain or loss is recognised in profit or loss or other comprehensive income, as appropriate.

10. Appendix A of IFRS 3 defines equity interests as:

> For the purposes of this IFRS, equity interests is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of mutual entities.

11. The divergent views noted in paragraph 8 mainly arise because of differing interpretations of the term 'equity interests' as used in paragraphs 41–42 of IFRS 3. The differing interpretations are as follows:

    (a) Proponents of View 1 (ie previously held interests are remeasured) note that the transaction represents a significant economic event that changes the nature of the investment and warrants a remeasurement of previously held interests. They consider the previously held net interest in the assets and liabilities of the joint operation to be the previously held 'equity interests', even though the entity is required to report directly its assets and liabilities and its share of the assets and liabilities related to the joint operation.

    (b) Proponents of View 3 (ie previously held interests are remeasured if the joint operation is structured through a separate legal entity) note that in instances in which the joint operation is not structured through a separate legal entity, the requirements of paragraphs 41–42 of IFRS 3 are not applicable, because there are no previously held 'equity interests' to be remeasured. They note that the remeasurement requirements would only be applicable in cases in which the joint operation was structured through a separate legal entity.

    (c) Proponents of View 2 (ie previously held interests are not remeasured) note that even in instances in which the joint operation is structured through a separate legal entity, IFRS 11 requires an entity to look through its equity interests and account directly for its share of the assets and liabilities of the joint operation. They think that there are no equity interests in a joint operation and the requirement to remeasure previously held interests in a business combination is not applicable.

Summary of the staff's analysis and the Interpretations Committee's discussions

12. The following section presents a summary of the staff's analysis and the discussions of the Interpretations Committee. Our full analysis of the issue can be found in Agenda Paper 5A of the Interpretations Committee meeting in September 2015.

13. As discussed in Agenda Paper 12B, the Interpretations Committee noted that the key factors that should be used in assessing whether previously held interests should be remeasured are:

    (a) the significance of the underlying economic event; and

    (b) the measurement model applicable to the recognition of the previously held/retained interests.

    Several members also noted that the structure of the investment, and whether or not it is structured through a separate legal entity, may have a bearing on the analysis and should be a relevant consideration.

Does the transaction represent a significant economic event?

14. Paragraph BC384 of IFRS 3 explains that there is a significant change in the nature of, and economic circumstances surrounding, the investment resulting from the acquisition of control, because the investor-investee relationship is replaced by a parent-subsidiary relationship. In particular:

    (a) the change warrants a change in the classification and measurement of the investment;

    (b) the acquirer is no longer the owner of a non-controlling investment asset in the acquiree;

(c) the acquirer ceases its accounting for an investment asset and begins reporting the underlying assets, liabilities and results of the operations of the acquiree in its financial statements; and

(d) in effect, the acquirer exchanges its status as an owner of an investment asset in an entity for a controlling financial interest in all of the underlying assets and liabilities of that entity (acquiree), together with the right to direct how the acquiree and its management use those assets in its operations.

15. The acquisition of control over a joint operation changes the nature of the investment and the nature of the relationship between the investor (who was previously either a joint operator or a party to the joint operation) and the business that has been acquired.

16. This is because the acquirer has exchanged its status as a joint controller or a party to a joint operation for a controlling interest in all the underlying assets and liabilities of the previous joint operation. It has acquired the right to *unilaterally direct* how the acquiree and its management use those assets in its operation. It has *unilateral decision-making power* over the wealth-generating abilities of the business.

17. Consequently, the Interpretations Committee concluded that the acquisition of control over a joint operation that is a business represents a significant economic event.

What is the applicable measurement model that should be applied to the previously held interests?

18. Paragraph 21 of IFRS 11 notes that a joint operator shall account for the assets, liabilities, revenues and expenses relating to its interests in a joint operation in accordance with the Standards applicable to the particular assets, liabilities, revenues and expenses. Some of those Standards, such as IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*, provide a cost-based model for initial recognition.

19. However, IFRS 3 provides guidance specific to business combinations and requires a fair value model to be applied to the initial recognition of identifiable assets and liabilities acquired in a business combination. It also requires previously held equity interests to be remeasured to fair value.

20. Because the acquisition of control over a joint operation (that constitutes a business) results in a business combination, the Interpretations Committee observed that the fair value measurement model of IFRS 3 should take precedence over the measurement models of the Standards that are applicable to the individual assets and liabilities. The Interpretations Committee concluded that remeasurement of previously held interests is consistent with the fair value measurement model in IFRS 3.

Does the structure of the joint operation affect the analysis of the appropriate accounting treatment?

21. The Interpretations Committee observed that the focus in developing the guidance on remeasurement in paragraph 42 of IFRS 3 was not on the structure of the investment, but on the substance of the underlying transaction and the change in the nature of the investment. This is evidenced by the rationale of the IASB in paragraph BC384 of IFRS 3 (see paragraph 14 of this paper).

22. Appendix A of IFRS 3 notes that 'for the purposes of this IFRS, *equity interests* is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of mutual entities'. A mutual entity is further defined as:

> … an entity, other than an investor-owned entity, that provides dividends, lower costs or other economic benefits directly to its **owners**, members or participants. For example, a mutual insurance company, a credit union and a co-operative entity are all mutual entities.

23. The definition of the term 'equity interests' in IFRS 3 does not require the existence of a separate legal entity. Some constituents have noted that a joint operation (whether or not it is structured through a separate legal entity) could meet the definition of a mutual entity, because it generally exists to provide some form of economic benefit to the joint operators and other parties to the joint arrangement.

24. The staff analysis noted that the term 'entity' is not a defined term within IFRS. The recently published Exposure Draft *Conceptual Framework for Financial Reporting* notes that a 'reporting entity' is (emphasis added) '*an entity* that chooses to, or is required, to present general purpose financial statements'. It could be argued that all joint operations, however they are structured, are entities, because they could choose

to (and in many cases, may be required to) prepare general purpose financial statements.

25. However, the staff analysis noted that it was not necessary for the Interpretations Committee or the IASB to determine whether a joint operation is an entity or a mutual entity to determine the appropriate treatment for the previously held interests.

26. When the IASB developed its recent guidance on the acquisition of interests in a joint operation, it noted in paragraph BC45M of IFRS 11 that:

    (a) the acquisition of additional interests in a business that is already controlled by the acquirer is analogous to the acquisition of interests in a business that is already jointly controlled by, and will continue to be jointly controlled by, the acquirer; and

    (b) the acquisition of control over a business by an acquirer is analogous to an acquirer obtaining joint control over a business.

    The IASB thought that there were grounds for developing an analogy to this guidance and did not distinguish between joint operations that are structured through a separate legal entity and those that are not.

27. On the basis of its analysis and of a review of the rationale of the IASB in determining the appropriate accounting for other similar transactions, the Interpretations Committee concluded that there should not be a different accounting treatment for joint operations that are structured through a separate legal entity versus those that are not.

Other considerations

Use of the cost accumulation model

28. Paragraph BC199 of IFRS 3 notes that users of financial statements have long criticised cost accumulation practices because they claim that they result in information that lacks consistency, understandability and usefulness. In developing the guidance in IFRS 3, the IASB concluded that no useful purpose is served by using a mixture of the fair values of the assets or liabilities at the date acquired and the acquirer’s historical costs or carrying amounts when reporting the assets or liabilities of a newly acquired business (see paragraph BC200 of IFRS 3).

29. The Interpretations Committee observed that the remeasurement of previously held interests is consistent with the rejection of cost accumulation practices by the IASB during the development of IFRS 3.

Exception in paragraph 38 of IFRS 3

30. Proponents of View 2 (previously held interests are not remeasured) point to paragraph 38 of IFRS 3, which states that:

> … sometimes the transferred assets or liabilities remain within the combined entity after the business combination … and the acquirer therefore retains control of them. In that situation, the acquirer shall measure those assets and liabilities at their carrying amounts immediately before the acquisition date and shall not recognise a gain or loss in profit or loss on assets or liabilities it controls both before and after the business combination.

31. They think that this exception is applicable because the assets and liabilities are accounted for as if they are direct assets and liabilities of the operators and they remain in the combined entity subsequent to the acquisition of control.

32. Paragraph 38 of IFRS 3 requires an entity to *retain control* of the assets and liabilities both before and after the transaction. Prior to this transaction, an acquirer only has joint control at best and subsequently obtains control of those assets and liabilities. Consequently, the Interpretations Committee does not think that this exception from the remeasurement requirements of IFRS 3 is applicable.

Interpretations Committee's conclusion and recommendation

33. On the basis of its analysis and discussions, the Interpretations Committee concluded that previously held interests <u>should be remeasured</u> to fair value when control is obtained over a joint operation that meets the definition of a business. The Interpretations Committee acknowledged that the current wording in paragraphs 41 and 42 of IFRS 3 could lead some to understand that previously held interests should not be remeasured when a joint operation is not structured through a separate legal entity.

34. Consequently, the Interpretations Committee has recommended an amendment to the guidance in IFRS 3 to make it clear that previously held interests should be remeasured in the transaction.

Proposed amendment to IFRS 3

35. The proposed amendment to IFRS 3 is shown in Appendix A of this Agenda Paper. The amendment makes it clear that the previously held interests should be remeasured when control is obtained over a joint operation that meets the definition of a business.

36. The proposed amendment has been included for information purposes only and the IASB will not be asked to provide comments on the wording at the meeting. Editorial comments on the draft wording, if any, should be sent to the staff outside of the meeting.

Transition provisions

37. The Interpretations Committee recommends that an entity should apply the amendments prospectively to business combinations occurring on or after the effective date. Earlier application should be permitted. It recommends a prospective approach for transition, because it observed that for transactions in which the previously held interests were not remeasured:

    (a) the application of this guidance on a retrospective basis may involve the use of hindsight in determining the acquisition-date fair value of the retained interests; and

    (b) the benefits of applying this guidance on a retrospective basis do not outweigh the costs and efforts.

Consequential amendments and first-time adopters

38. We reviewed the other Standards for potential consequential amendments triggered by this proposed amendment. As a result of this review, it does not propose any consequential amendments.

39. We also considered whether special provisions are required for first-time adopters to IFRS. Appendix C of IFRS 1 *First-time Adoption of International Financial Reporting Standards* already provides an exemption from retrospective restatement of past business combinations. Paragraph C1 of IFRS 1 states:

> An first-time adopter may elect not to apply IFRS 3 retrospectively to past business combinations (business combinations that occurred before the date of transition to IFRSs).

40. Consequently, the Interpretations Committee does not think a clarifying amendment to IFRS 1 is necessary.

Assessment against the criteria for annual improvements

41. The Interpretations Committee assessed the proposed amendment against the criteria for annual improvements, as shown in the following table:

Criteria for annual improvements	
An annual improvement should (6.11, 6.12): • replace unclear wording; • provide missing guidance; or • correct minor unintended consequences, oversights or conflict.	**Yes.** The Interpretations Committee observed that the guidance currently does not address the situation described by the submitter and it noted that the current wording in paragraphs 41–42 of IFRS 3 could lead some to understand that previously held interests should not be remeasured. The Interpretations Committee does not think that this was an intended consequence of the wording in these paragraphs.
Not change an existing principle or propose a new principle.	**Yes.** The Interpretations Committee noted that the proposal is not changing an existing principle or proposing a new principle. Instead, it thinks that the proposal is providing missing guidance that is in line with the principles of IFRS 3.

Criteria for annual improvements	
Not be so fundamental that the IASB will have to meet several times to conclude (6.14).	**Yes.** The Interpretations Committee thinks that the proposed amendment is not so fundamental that the IASB will have to meet several times to conclude.

42. On the basis of this assessment the Interpretations Committee thinks that the proposed amendment meets the criteria for inclusion in the *Annual Improvements to IFRS 2015–2017* Cycle.

Questions for the IASB

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1. Does the IASB agree with the Interpretations Committee's analysis and conclusion that the previously held interests in the assets and liabilities of a joint operation should be remeasured when control is obtained over the former joint operation that constitutes a business?
2. Does the IASB agree with the Interpretations Committee's conclusion that the proposed amendment meets the criteria for inclusion in the *Annual Improvements to IFRS 2015–2017* Cycle?
3. Does the IASB agree with the Interpretations Committee's recommendation that the proposed amendment should be applied on a prospective basis with early application permitted?

Appendix A
Proposed amendment to IFRS 3 *Business Combinations*

A1. Appendix A provides a draft of the proposed amendment to IFRS 3. This information has been included for information purposes only and the IASB will not be asked to provide comments on the wording at the meeting. Editorial comments on the draft wording, if any, should be sent to the staff outside of the meeting.

Paragraphs 42A and 64M have been added. Paragraphs 41–42 have not been amended but have been included for ease of reference. New text is underlined.

A business combination achieved in stages

41 An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on 31 December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, Entity A purchases an additional 40 per cent interest in Entity B, which gives it control of Entity B. This IFRS refers to such a transaction as a business combination achieved in stages, sometimes also referred to as a step acquisition. <u>.</u>

42 In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

<u>42A For the purposes of a business combination achieved in stages, equity interests shall also include an acquirer's interests in the assets and liabilities of a joint operation held immediately before the acquisition date.</u>

Effective date

<u>64M [Draft] Annual Improvements to IFRS [2015–2017] Cycle, issued in [date], added paragraph 42A. An entity shall apply that amendment prospectively to transactions occurring in annual periods beginning on or after [date]. Earlier application is permitted.</u>