IFRS

STAFF PAPER

June 2017

IFRS Interpretations Committee Meeting

Project	**Acquisition of an associate or joint venture from an entity under common control**		
Paper topic	Initial consideration		
CONTACT(S)	Satenik Vanyan	svanyan@ifrs.org	+44(0)20 7246 6924

Introduction

1. In 2013, the IFRS Interpretations Committee (the Committee) discussed how an entity accounts for the acquisition of an interest in an associate or joint venture from an entity under common control. In particular, the submission considered whether an entity could apply by analogy the scope exception for business combinations under common control (BCUCC) in IFRS 3 *Business Combinations*.

2. The Committee discussed the matter at its meetings in January 2013 and May 2013. The Committee noted that it would be better to consider this matter within the context of broader projects on BCUCC and the equity method of accounting. Consequently, the Committee decided not to add this matter to its agenda. Appendix B to this paper reproduces the agenda decision published by the Committee in May 2013 for reference.

3. The BCUCC project is an active project on the International Accounting Standards Board's (the Board) work plan. In addition, the Board's research pipeline includes a project on the equity method. The Board, however, has already decided that the scope of the BCUCC project will focus on business combinations under common control and group restructurings excluded from IFRS 3—the project will not address this matter. In addition, although the Board has not yet determined the scope of the equity method research project, we understand from the project team that, given the areas of

focus for the project, the Board is unlikely to consider this matter as part of that project.

4. In the light of the Board's recent discussions on its work plan, at the Committee meeting in March 2017, the Committee decided to reconsider how an entity accounts for the acquisition of an interest in an associate or joint venture from an entity under common control.

5. The purpose of this paper is to:

   (a) provide the Committee with a summary of the matter and our analysis and research; and

   (b) ask the Committee whether it agrees with our recommendation not to add this matter to its standard-setting agenda.

Structure of the paper

6. This paper includes:

   (a) background;

   (b) staff analysis; and

   (c) staff recommendation.

7. There are 2 appendices to the paper:

   (a) Appendix A—Proposed wording of the tentative agenda decision; and

   (b) Appendix B—Agenda decision published in May 2013.

Background

Summary of the matter

8. In the fact pattern discussed by the Committee in 2013, an entity acquires an interest in an associate or joint venture from an entity under common control (the transaction).

9. We understand there is diversity in practice in how entities account for the transaction. An entity applies one of the following two views:

(a) *View A: apply the requirements in IAS 28*

Proponents of this view note that IAS 28 *Investments in Associates and Joint Ventures* does not include a scope exception for the acquisition of an interest in an associate or joint venture from an entity under common control. Accordingly, an entity applies IAS 28. If it uses the equity method to account for its interest in the associate or joint venture, the entity recognises its acquired interest at cost. The entity might then adjust that initial cost measurement as required by paragraph 32 of IAS 28:

> 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. …

(b) *View B: apply by analogy the BCUCC scope exception in IFRS 3*

Paragraph 26 of IAS 28 states (emphasis added):

> 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.

Paragraph 2(c) of IFRS 3 states that IFRS 3 does not apply to 'a combination of entities or businesses under common control'.

Proponents of this view say that, because IFRS 3 provides a scope exception for the acquisition of subsidiaries under common control and the concepts applied are similar, an entity can apply by analogy the exception in paragraph 2(c) of IFRS 3.

IFRS Standards do not specify how to account for a business combination under common control. We understand that there is diversity in how entities account for such transactions—for example, depending on the facts and circumstances, some entities apply a predecessor approach in which the acquirer does not remeasure the assets and liabilities acquired while others may account for the acquisition by recognising the assets and liabilities acquired at fair value. Accordingly, entities applying this view might recognise the acquired interest in the associate or joint venture at its share of the investee's previous carrying amount or at fair value.

Summary of previous Committee discussions

10. The Committee discussed this matter at its meetings in January 2013 and May 2013. A majority of Committee members agreed that IAS 28 does not provide a scope exception for the acquisition of an interest in an associate or joint venture, and accordingly an entity applies IAS 28 to account for the transaction (ie—View A described in paragraph 9 of this paper). Nonetheless, some members were concerned that the outcome of applying the requirements in IAS 28 might not be appropriate. They were also concerned that applying IAS 28 might create opportunities for entities to structure transactions to achieve a particular accounting outcome. We have analysed these concerns in paragraphs 27-39 of this paper.

11. The Committee concluded that it would be better to consider the transaction within the context of the broader projects on BCUCC and the equity method. Appendix B to this paper reproduces the agenda decision published in 2013.

Staff analysis

12. In this section, we first analyse how an entity applies the requirements in IFRS Standards to the transaction. In doing so, we consider whether the entity can apply by analogy the BCUCC scope exception in IFRS 3. We then consider whether the application of the requirements in IAS 28 could lead to anomalous results or create structuring opportunities in particular situations.

Application of IFRS requirements

Can an entity apply by analogy the BCUCC scope exception in IFRS 3?

13. IAS 28 does not exclude from its scope transactions with entities under common control. Paragraph 2 of IAS 28 states that:

> This Standard shall be applied by all entities that are investors with joint control of, or significant influence over, an investee.

14. Unless the exemptions in paragraphs 17-19 of IAS 28 apply or the interest is classified as held for sale, an entity uses the equity method to account for its interest in an associate or joint venture. In that case, an entity applies the requirements in paragraphs 10 and 32 of IAS 28 to the transaction. Paragraph 10 of IAS 28 states:

> …on initial recognition the investment in an associate or a joint venture is recognised at cost…

15. Paragraph 32 of IAS 28—see paragraph 9(a) above—specifies how an entity accounts for 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.

16. These paragraphs do not distinguish between the acquisition of an interest in an associate or joint venture from an entity under common control and the acquisition of such an interest from an unrelated entity.

17. Paragraph 26 of IAS 28 states that an entity adopts the concepts underlying the procedures used in accounting for the acquisition of a subsidiary in accounting for the acquisition of an investment in an associate or joint venture. That paragraph refers to the concepts underlying *the procedures used*, and not to the scope of IAS 28 or IFRS 3. Paragraph 26 also sits under the heading 'Equity method procedures'—the section

of IAS 28 that specifies the procedures that an entity uses when applying the equity method.

18. Paragraph 2(c) of IFRS 3 provides a scope exception for business combinations under common control. The acquisition of an interest in an associate or joint venture is not a business combination. In our view, it is inappropriate for an entity to apply an exemption or exception by analogy. Exceptions and exemptions in IFRS Standards provide entities with targeted relief from applying the general principles and requirements in IFRS Standards in particular situations—in our view, exceptions and exemptions do not establish principles or concepts that an entity can apply by analogy to other situations. Applying an exception or exemption by analogy would result in an entity not applying requirements that specifically apply to the particular transaction in question.

19. In addition, we note that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specifies that an entity considers requirements in IFRS Standards dealing with similar and related issues only in the absence of a Standard that specifically applies to the transaction. In this case, IAS 28 applies to the transaction.

20. Accordingly, we think that an entity cannot apply the BCUCC scope exemption in IFRS 3 to the transaction.

Applying the requirements in paragraph 32 of IAS 28 to common control transactions

21. In a common control transaction, the consideration an entity gives in exchange for acquiring an interest in an associate or joint venture may not represent the fair value of that interest, ie the price for the interest in an orderly transaction between market participants.

22. Paragraph 10 of IAS 28 requires an entity to recognise its investment in an associate or joint venture initially at cost. Nonetheless, paragraph 32 of IAS 28—see paragraph 9(a) above—requires an entity to recognise any difference between the cost and the entity’s share of the net fair value of the associate or joint venture’s identifiable assets and liabilities as goodwill (if cost is greater than fair value) or as income (if cost is less than fair value).

23. Some or all of the difference between the consideration an entity pays and the net fair value of its share of the investee's identifiable assets and liabilities in a common control transaction could be the result of a transaction with owners in their capacity as owners. For example, if the consideration an entity pays to acquire an interest in an associate from an entity under common control is CU80, and the entity's share of the fair value of the associate's identifiable assets is CU100, the difference of CU20 could represent a capital contribution from the parent entity. Nonetheless, some might say that paragraph 32 of IAS 28 requires the entity to recognise this difference as income in the statement of profit or loss. In their view, this would conflict with the requirements in paragraph 106(d)(iii) of IAS 1 *Presentation of Financial Statements*, which states that the statement of changes in equity includes the following information:

> ….
>
> d) for each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from: …
>
> > iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.

24. In our view, there is no conflict. IAS 28 does not define the cost of an investment. Depending on specific facts and circumstances, we think an entity could consider the cost, for purposes of applying the requirements in IAS 28, to include a capital contribution or be reduced by a capital distribution. Taking the example in paragraph 23 above, if the difference of CU20 represents a capital contribution by the parent entity, the cost of the investment is CU100—the cash paid of CU80 and the capital contribution of CU20. Accordingly, there is no difference between the cost and the entity's share of the net fair value of the investee's identifiable assets and liabilities.

25. We think that the requirements in paragraph 32 of IAS 28 do not conflict with the requirement in IFRS Standards to recognise directly in equity transactions with owners in their capacity as owners.

Conclusion

26. We think an entity applies the requirements in IAS 28 when it acquires an interest in an associate or joint venture under common control—it does not apply by analogy the BCUCC scope exception in IFRS 3. Applying these requirements, the entity recognises the interest in the associate or joint venture at cost, subject to the requirements in paragraph 32 of IAS 28. In accounting for the transaction, the entity assesses whether the acquisition of the interest includes a transaction with owners in their capacity as owners. If so, the entity determines the cost of the investment taking into account that transaction with owners.

Does applying the requirements in IAS 28 lead to anomalous outcomes or give rise to structuring opportunities?

27. As mentioned in paragraph 10 of this paper, at its meeting in January 2013, a majority of Committee members agreed that an entity applies IAS 28 to the transaction. Nonetheless, some members were concerned that the outcome of applying IAS 28 might not be appropriate in some situations, and that applying IAS 28 might create opportunities for entities to structure transactions to achieve a particular accounting outcome.

28. In particular, those members were concerned that applying IAS 28 to account for the acquisition of an associate or joint venture could lead to:

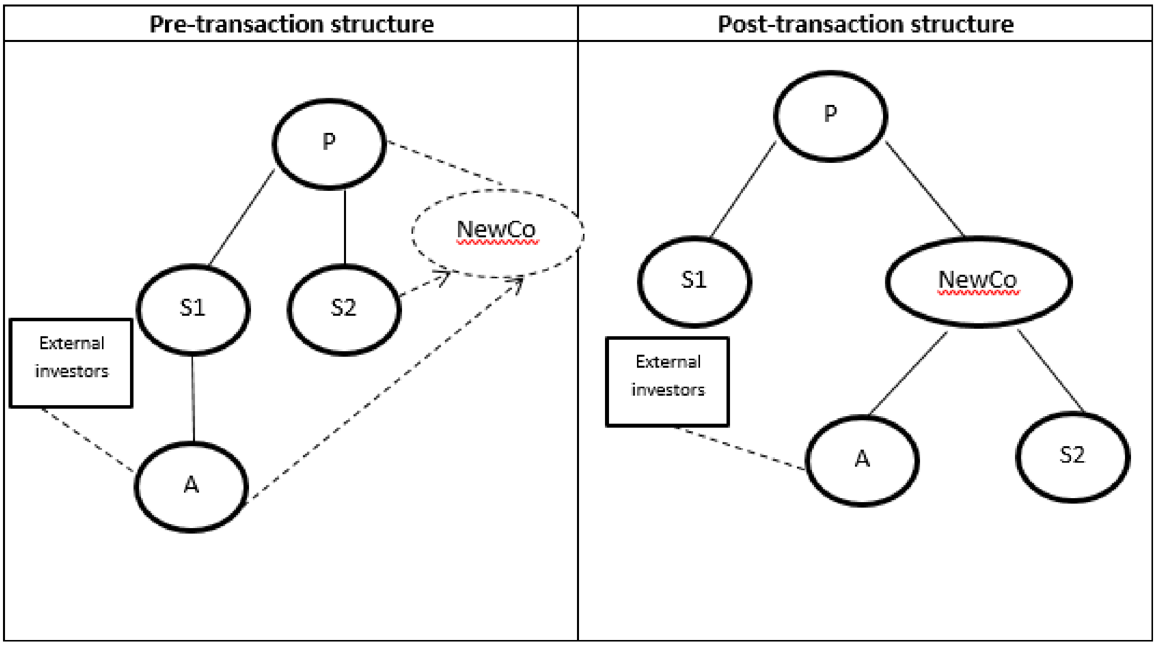
    (a) anomalous outcomes in group restructurings in which an entity creates a new entity (NewCo) and transfers interests in subsidiaries and associates to Newco. In this case, applying paragraph 32 of IAS 28, NewCo would recognise the interests in associates at its share of the fair value of each associate's identifiable assets and liabilities (or at cost, if higher). However, it could recognise the assets and liabilities of subsidiaries at their previous carrying amounts.

    (b) structuring opportunities because an entity could apply a different accounting treatment depending on whether it acquires the interest in the associate directly, or indirectly by acquiring the shares of a holding company.

Issue I – Potentially anomalous outcomes in group restructurings

29. As outlined in paragraph 28(a) above, one of the concerns some members raised was about the potentially anomalous outcomes in some group restructurings.

Example



30. In this example, the parent company sets up a new entity (NewCo) and transfers interests in a subsidiary (S2) and an associate (A) to NewCo.

31. **Acquisition of S2** - In the consolidated financial statements of Newco, the acquisition of S2 is outside of scope of IFRS 3, applying paragraph 2(c) of IFRS 3. IFRS Standards do not contain requirements on how Newco would account for the acquisition of its interest in S2. NewCo might recognise its interest in S2 at the previous carrying amounts of S2's assets and liabilities in some situations.

32. **Acquisition of A** – NewCo applies the requirements in IAS 28 to account for the acquisition of its interest in A. NewCo recognises its investment in A at cost, adjusted to reflect its share of the fair value of A's identifiable assets and liabilities if the cost is less that its share of the net fair value. This is the case regardless of whether NewCo pays cash or issues shares to obtain A.

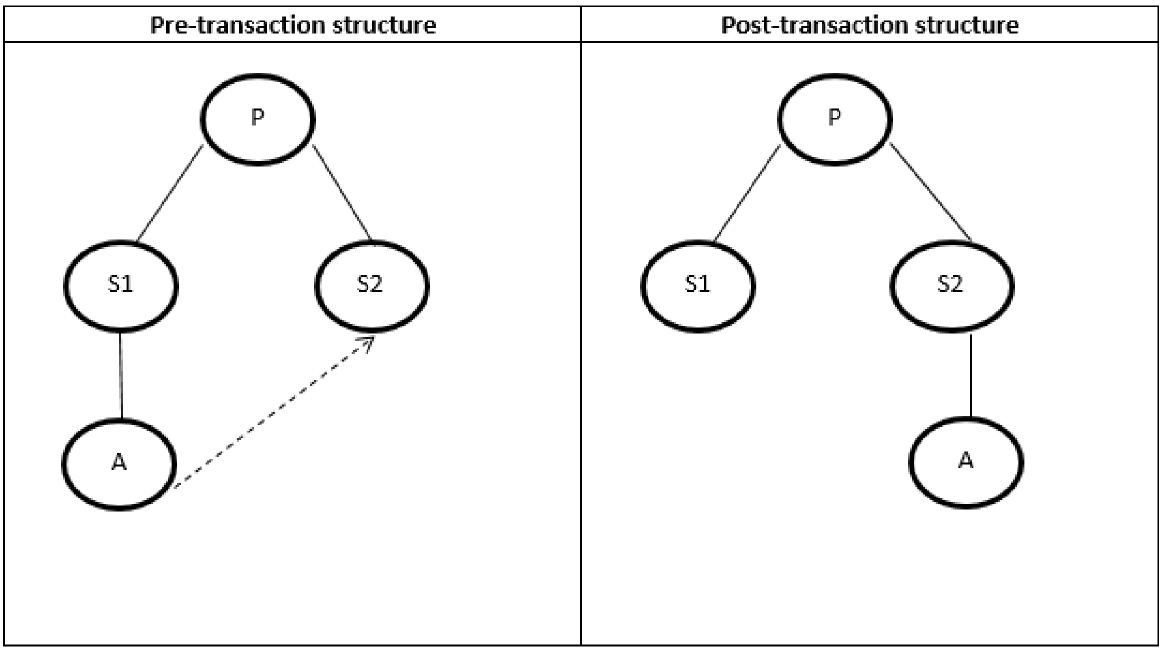
Is the outcome anomalous?

33. The nature of the relationship between an entity and its subsidiary is different from the nature of its relationship with an associate—an entity controls a subsidiary whereas it has significant influence over an associate. The method of accounting for a subsidiary—consolidation of the assets and liabilities of the subsidiary—is also different from the method of accounting for an associate—as a single-line investment asset. We also note that an associate would typically have third-party investors, whereas a subsidiary may be wholly-owned by the parent entity. Consequently, we think the outcomes in a group restructuring are not anomalous; rather, they reflect the different nature of the investments.

Issue II – Potential structuring opportunity.

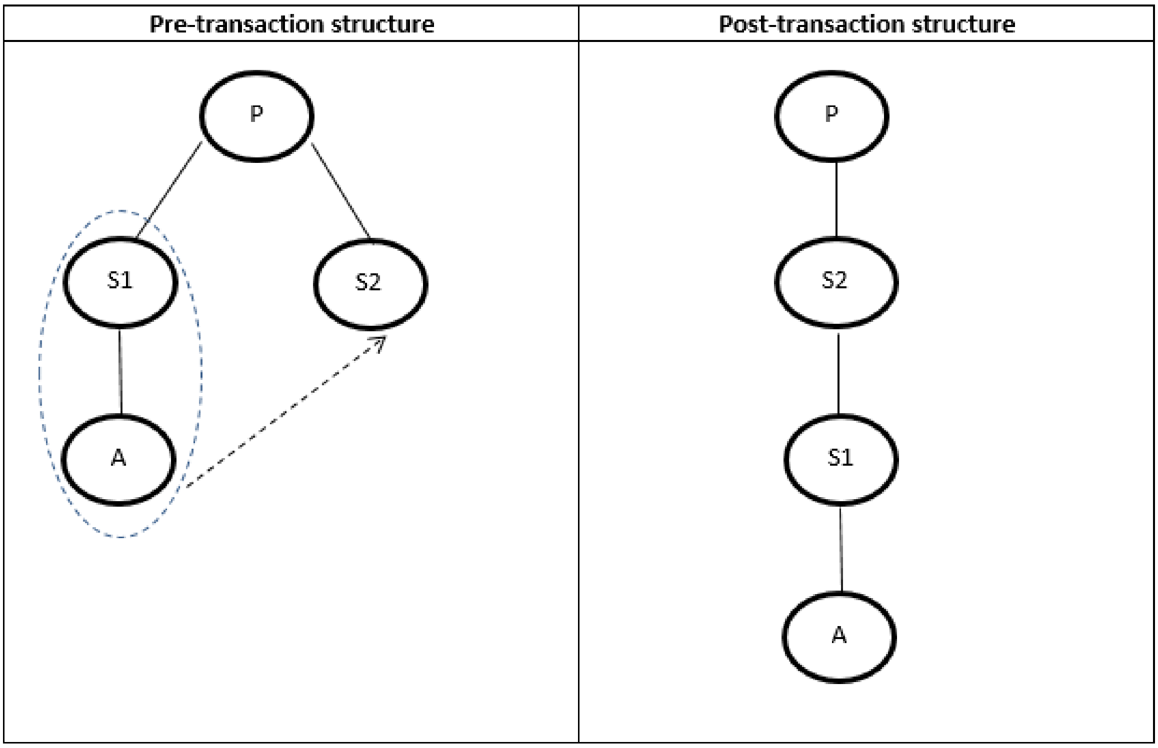
34. As outlined in paragraph 28(b) above, another concern raised was that an entity could apply a different accounting treatment depending on whether it acquires the interest in the associate directly, or indirectly by acquiring the shares of a holding company.

35. In this example, S1 is a holding company that holds the parent's (P) interest in associate A. S2, a subsidiary of P, acquires this interest directly from S1.



36. In its financial statements, S2 applies the requirements in IAS 28 to account for its interest in A—accordingly, it recognises the acquisition of its interest in A at cost, adjusted to reflect its share of the fair value of A's identifiable assets and liabilities if the cost is less that its share of the net fair value.

37. In contrast, in the example below, S2 acquires the interest in S1 and indirectly obtains the interest in A.



38. Some say that in this scenario, S2 acquires a subsidiary—accordingly, it applies the BCUCC scope exception in IFRS 3. However, IFRS 3 defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses. Because S1 is a holding company and holds only the interest in A, the acquisition of S1 is not a business combination—this is because S2 does not obtain control of a business—it obtains only significant influence over A. Accordingly, S2 has acquired an interest in an associate (A) and accounts for the transaction applying the requirements in IAS 28.

Potential structuring opportunities?

39. We think applying the requirements in IAS 28 does not create structuring opportunities. This is because the entity applies the same requirements, regardless of

whether it obtains the associate directly or indirectly by acquiring the shares of a holding company.

Question 1 for the Committee

Does the Committee agree with our analysis of the requirements in IFRS Standards, ie if an entity acquires an interest in an associate or joint venture from an entity under common control, it applies the requirements in IAS 28 to account for the acquisition of its interest—it cannot apply by analogy the BCUCC scope exception in IFRS 3?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[1]

40. Based on our analysis, we think that the requirements in IFRS Standards—in particular, the requirements in IAS 28— provide an adequate basis for the entity to account for the transaction.

41. Nonetheless, we have assessed whether the Committee should recommend an amendment to IAS 28 to exclude from the scope of that Standard the acquisition of interests in an associate or joint venture from an entity under common control.

Potential scope exception in IAS 28?

42. Some might say that providing a scope exception in IAS 28 for common control transactions would achieve consistency with other IFRS Standards that exclude common control transactions from their scope, such as IFRS 3 and IFRIC 17 *Distribution of Non-Cash Assets to Owners*. In their view, the Board should provide a scope exception now, and then consider the accounting for acquisitions of associates and joint ventures under common control after the Board has completed its BCUCC project. They also might say that requiring entities to apply the requirements in IAS 28 to common control transactions results in additional cost—to determine the fair

[1] Paragraph 5.16(b) of the *Due Process Handbook*.

value of the identifiable assets and liabilities—which the entity would not incur if it could use previous carrying amounts to account for the transaction.

43. We do not agree. We think the Committee should not propose such an exception. This is because the requirements in IAS 28 apply to all acquisitions of interests in an associate or joint venture. If transactions between entities under common control are excluded from the scope of IAS 28, there would be no requirements in IFRS Standards that specifically apply to these transactions—in our view, this is likely to increase diversity in practice and, thus, would not improve financial reporting. We also think that the outcome of an entity applying IAS 28 provides useful information to users of the entity's financial statements. In each of the examples in this paper, we note that the accounting applied by the parent entity does not change if the group restructuring transactions are just that, and thus do not change the overall interests of the parent entity in each of its subsidiaries and associates.

44. In addition, although the Board currently has an active project on its work plan that will address the accounting for BCUCC transactions, it does not have a project on its work plan (or in its research pipeline) that would address the accounting for the transaction.

Staff recommendation

45. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16-5.17 of the *Due Process Handbook* (discussed above in paragraphs 40-44 above), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that outlines how an entity applies the applicable requirements in IFRS Standards to the transaction.

46. The proposed agenda decision would replace the previous agenda decision on this matter issued in May 2013 (reproduced in Appendix B). At that time, the Committee expected the Board to consider the transaction as part of its projects on BCUCC or the equity method of accounting in the relatively near future. However, the Board's most recent discussions on its work plan indicate that it is unlikely to consider the transaction for some considerable time. The proposed tentative agenda decision

would reiterate much of the analysis in the previous agenda decision, but would remove any doubt about how to account for the transaction.

47. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A – Proposed wording of the tentative agenda decision

IAS 28 *Investments in Associates and Joint Ventures*—Acquisition of an associate or joint venture from an entity under common control

The Committee discussed a request to clarify how to account for the acquisition of an interest in an associate or joint venture from an entity under common control. In particular, the submitter asked whether it is appropriate to apply by analogy the scope exception for business combinations under common control in paragraph 2(c) of IFRS 3 *Business Combinations*.

The Committee observed that IAS 28 does not include a scope exception for the acquisition of an interest in an associate or joint venture from an entity under common control. Accordingly, an entity applies the requirements in IAS 28 when it acquires such an interest. The Committee concluded that the entity does not apply by analogy the scope exception for business combinations under common control in IFRS 3. In accounting for the acquisition of the interest, the entity assesses whether the transaction includes a transaction with owners in their capacity as owners—if so, the entity determines the cost of the investment taking into account that transaction with owners.

The Committee concluded that the requirements in IFRS Standards provide an adequate basis for an entity to account for the acquisition of an interest in an associate or joint venture from an entity under common control. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—Agenda decision published in May 2013

B1. In October 2012, 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, which is set out in IFRS 3 *Business Combinations*, by analogy to the acquisition of an interest in an associate or joint venture under common control.

B2. 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 only in the absence of a Standard that specifically applies to a transaction.

B3. The Interpretations Committee also observed 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. That paragraph 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. The Interpretations Committee also observed that paragraph 2(c) of IFRS 3 states that IFRS 3 does not apply to a combination of entities or businesses under common control. The Interpretations Committee observed that some might read these paragraphs as contradicting the guidance in paragraph 32 of IAS 28, and so potentially leading to a lack of clarity.

B4. The Interpretations Committee was specifically concerned that this lack of clarity has led to diversity in practice for the accounting of the acquisition of an interest in an associate or joint venture under common control.

B5. The Interpretations Committee noted that accounting for the acquisition of an interest in an associate or joint venture under common control would be better considered within the context of broader projects on accounting for business combinations under common control and the equity method of accounting. The Interpretations Committee also noted that the IASB, in its May 2012 meeting, added a project on accounting for business combinations under common control as one of the priority research projects as well as a project on the equity method of accounting as one of the research activities to its future agenda. Consequently, the Interpretations Committee decided not to take this issue onto its agenda.