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STAFF PAPER

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Project	**Equity Method**
Paper topic	Project scope—application questions

CONTACT(S) Filippo Poli fpoli@ifrs.org
Hazirah Hasni hhasni@ifrs.org

Introduction

1. In this session the Global Preparers Forum (GPF) members are asked for their views on:

   (a) the importance of application questions within the scope of the International Accounting Standard Board's (Board) Equity Method research project and their experience with these application questions; and

   (b) the application questions with recurrent themes currently excluded from the scope of the project and their experience with these application questions.

Structure of the paper

2. The paper is structured as follows:

   (a) project background;

   (b) application questions within the scope of the project;

   (c) application questions with recurrent themes currently excluded from the scope of the project; and

   (d) Appendix—criteria and process for selecting the application questions.

Project background

3. IAS 28 *Accounting for Investments in Associates* was issued in 1989 and revised in 2003 and 2011. Over time application questions have been raised on different aspects of the equity method, some of which have been addressed by amendments to the Standard or agenda decisions by the IFRS Interpretations Committee (Committee).

Objective and approach of the project

4. At its October 2020 meeting, the Board discussed the objective and approach of the Equity Method research project. The Board decided that the objective of the Equity Method research project is:

> To assess whether application questions with the equity method, as set out in IAS 28 *Investments in Associates and Joint Ventures*, can be addressed in consolidated and individual financial statements by identifying and explaining principles in IAS 28.[1]

5. The Board decided that to achieve the objective, it would apply the following approach:

   (a) identify application questions and decide which of these questions to address; and

   (b) address the application questions by identifying and explaining the principles in IAS 28.

6. Input from financial statement preparers and users is important to achieve the objective in paragraph 5(a) of this paper and establish the scope of the research project, so that it does not attempt to resolve problems that are not clearly identified.

[1] October 2020 IASB Board meeting AP13: Project objective and approach (ifrs.org)

Process for selecting the application questions within the scope of the project

7. At its March 2021 meeting, the Board discussed a process for selecting application questions for consideration in the project.[2] The appendix to this paper illustrates the criteria and process for selecting application questions.

8. The staff applied the selection process to a list of application questions identified from previous submissions to the Committee, past work of the Board, previous discussion with GPF members and other activities. Paragraphs 13–20 of this paper present the application questions within the scope of the project.

9. Applying the criteria in the selection process, the staff excluded some application questions with recurrent themes. The staff plan to make the Board aware of these questions, so the Board can consider whether these questions warrant extending the scope of the project. Paragraphs 21–35 of this paper present the application questions with recurrent themes currently excluded from the scope of the project.

10. The staff considers the selection of application questions to be an iterative process. As the project progresses, it may be that solutions can be found to application questions that have been excluded or conversely solutions found could raise new questions. Therefore, staff will continue to reassess the application questions included in the scope of the project.

Application questions within the scope of the project

11. Applying the criteria agreed with the Board the staff has identified and grouped the application questions by topic, in paragraphs 13–20 of this paper.

12. For simplicity, the application questions refer to associates and joint ventures accounted for applying IAS 28 as “investees” when describing the application question.

[2] March 2021 IASB Board meeting [AP13: Project update and next steps (ifrs.org)]

Increases and decreases in an investor's interest without a change in significant influence

13. There are two application questions in the scope of the project for this topic:

    (a) Paragraph 32 of IAS 28 requires an investor to measure its share of the investee's identifiable assets and liabilities at their fair value at the date significant influence is obtained. The application question arising is when the investor increases its interest in the investee without a change in significant influence:

        (i) if and how does the investor measure the additional share of the investee's net assets; and

        (ii) if the investor's additional share of the investee's identifiable net assets is measured at an amount different from the consideration paid, how does the investor account for the difference.

    (b) An investee may issue shares to other investors resulting in a dilution of the investor's interest. The application question is how to present the change in the measurement of the investor's interest from various events that do not affect significant influence.

Recognition of losses

14. Applying paragraphs 38 and 39 of IAS 28, when an investor's interest in its investee is reduced to zero, the investor discontinues recognising its share of further losses. It resumes recognising its share of profit only after its share of profit equals the share of losses not recognised. The following application questions are related to paragraphs 38 and 39 of IAS 28.

    Whether an investor that has reduced its interest in an investee to nil:

    (a) is required to 'catch up' unrecognised losses if it purchases an additional interest in the investee. The staff note that to address this question, the Board will need to address how to account for increases in an investor's interest without a change in significant influence (see paragraph 13).

(b) continues eliminating its share of gains arising from a downstream transaction.

(c) recognises each component of comprehensive income separately. For example, in a financial year, an investee recognises a loss in comprehensive income that includes, a profit in its statement of profit and loss, and a loss in its statement of other comprehensive income.

Transactions between investor and associate

15. Applying paragraph 28 of IAS 28, an investor is required to eliminate its share of gain or loss in an upstream and downstream transaction with an investee. The following application questions are related to paragraph 28:

(a) in a downstream transaction, whether to recognise the portion of the investor's share of gain that exceeds the carrying amount of its investment in the investee.

(b) in an upstream transaction, whether the investor's share of gain or loss is eliminated from the carrying amount of the investment in the investee or the acquired asset.

(c) if the provision of service and transactions that are not transfer of assets are upstream or downstream transaction.

(d) how should an investor account for gains and losses that arise from the sale of a subsidiary to an investee given the conflicting requirements between IFRS 10 *Consolidated Financial Statements* and IAS 28. In a transaction where an investor sells a subsidiary to its investee, paragraph 25 of IFRS 10 requires the investor to recognise in full the gain or loss from the sale of a subsidiary, remeasuring any retained interest whereas paragraph 28 of IAS 28 requires an investor to eliminate the gain or loss to the extent of the retained interest in the former subsidiary.

Transactions between two associates

16. Paragraph 26 of IAS 28 states that procedures appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. The application question is whether the adjustment of gains and losses in intra-group transactions between subsidiaries should be applied by analogy to transactions between investees under the equity method.

Share of other changes in net assets

17. The application question is whether an investor recognises its share of the investee's other changes in net asset as result of transactions other than distributions received, and if so, how the investor's share of other changes in net assets is presented.

Impairment

18. According to paragraph 41B of IAS 28, in assessing impairment of the net investment in an investee, a decline in fair value of the investee may be evidence of impairment when considered with other available information. The application question seeks clarification as to whether the decline in fair value is assessed in relation to the original purchase price or the carrying amount at the reporting date.

Initial recognition

19. Paragraph 32 of IAS 28 requires an investor to recognise its share of the fair value of the investee's net assets at the date significant influence is obtained. The application question is whether the investor recognises deferred tax assets and liabilities on the differences between the fair value and the tax base of its share of the investee's net assets.

Contingent consideration

20. IAS 28 does not provide specific guidance in accounting for contingent consideration arising on the acquisition of an investee. The application question seeks clarification on the initial and subsequent accounting for contingent consideration in the

acquisition of an investee applying IAS 28. In practice, paragraph 39 of IFRS 3 *Business Combinations* is commonly referenced as paragraph 26 of IAS 28 states that the application of the equity method is similar to the consolidation procedures, and IFRS 3 provides guidance on the initial recognition and subsequent measurement for contingent consideration arising on the acquisition of subsidiaries.

Application questions with recurrent themes currently excluded from the scope of the project

Ownership interests that provide access to benefits

21. The first group of application questions concerns which ownership interests in an investee are considered in determining the cost of the investment.

22. IAS 28 states:

    (a) When potential voting rights or other derivatives containing potential voting rights exist, an entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments, unless paragraph 13 of IAS 28 applies. (paragraph 12 of IAS 28)

    (b) In some circumstances, an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the returns. (paragraph 13 of IAS 28)

    (c) When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in an associate or a joint venture, the instruments are not subject to IFRS 9 *Financial Instruments* (paragraph 14 of IAS 28).

23. Feedback on the initial list of application questions included that there are challenges in determining which instruments should be considered part of the cost of the investment. Instruments identified include redeemable preference shares/perpetual instruments. Furthermore, questions included whether instruments with different features should be bifurcated and IFRS 9 and IAS 28 applied to the relevant components of the instrument.

24. The feedback also noted that investees may have several classes of equity shares with varying entitlements to net profits, equity or liquidation preferences. Some instruments may also have entitlements that vary over the economic life of the investee or change upon reaching determined thresholds. In these circumstances, determining the appropriate percentage of ownership interest may be challenging.

25. In applying the selection process, the group of application questions was excluded because they related to the scope of application of the equity method whereas the project's scope is limited to application questions with the equity method. The Board has directed the staff to undertake a project to consider application questions with the equity method.

26. Furthermore, the staff noted that addressing this group of questions may potentially involve changing the scope of application of the equity method. The project will not reconsider significant influence as the basis to apply the equity method or redefine significant influence. There is a possibility that addressing these application questions could lead to a broader reconsideration of significant influence. For this reason, the staff initial assessment is that these application questions are outside the project's scope.

27. However, given that these application questions were included in the feedback from several participants and that in the view of some participants these questions are the most pressing concern with the application of IAS 28 staff considers the matter should be highlighted to the Board.

Reciprocal interests

28. Reciprocal interests can occur when an investee holds an interest in an investor or an investor's subsidiary. Reciprocal interests can give rise to double counting of net assets between the investor and the investee and IAS 28 does not include requirements on how to address this question.

29. In April 2003, the Committee considered circumstances in which entity A owns an interest in entity B, and entity B concurrently owns an interest in entity A. The Committee decided not to develop an interpretation on this issue because paragraph 20 of IAS 28 requires elimination of reciprocal interests (through application of consolidation concepts). The Committee noted these issues should be reconsidered once the Business Combinations phase II project was finalised.

30. In applying the selection process, questions on reciprocal interests were excluded because it was considered that those application questions could not be solved without amending other IFRS Standards. That is, they relate to how an investor determines the effective ownership interest needed to apply equity method, however, the project scope is restricted to when applying the equity method.

Non coterminous reporting period and uniform accounting policies

31. Paragraph 33 of IAS 28 requires the financial statements of the associate or joint venture to be prepared as of the same date as the financial statements of the reporting entity, unless it is impracticable to do so. When the financial statements are prepared as of a different date, the difference between the two reporting dates shall be no more than three months and adjustments shall be made for the effects of significant transactions or events that occur between the two dates.

32. Paragraph 35 of IAS 28 requires an investor to use financial statements of the investee that are prepared using uniform accounting policies for like transactions and events in similar circumstances.

33. Feedback on the initial list of application questions included that an investor may not have sufficient information to comply with the requirements in paragraphs 33 to 35

of IAS 28 and/or the ability to require the investee to provide the necessary information.

34. In addition, it was noted that there may be restrictions in using the financial statements of an investee when the investor issues its financial statements before the investee, and the investee is a listed entity.

35. In applying the selection process, these questions were excluded because it was considered the application question could not be resolved without fundamentally rewriting IAS 28. The application questions were not related to either clarity or missing requirements; but practical application of IAS 28 requirements. The questions raised in paragraphs 31 and 32 of this paper are a matter of practicality and cost in applying the requirements, not a matter of explaining the principles that underlie the equity method.

Questions for GPF members
1. What are GPF members' views on the importance of application questions within the scope of the project in paragraphs 13–20 and their experience with these application questions? How frequently do they arise, how is IAS 28 currently applied and what are the challenges? 2. What are GPF members' views on the application questions with recurrent themes currently excluded from the scope of the project in paragraphs 21–35? Are these questions frequent and what are the challenges? 3. Is there any other information on any of these application questions that you would like the staff to share with the Board?

Appendix—Criteria and process for selecting the application questions