IASB® meeting

Date	**March 2023**
Project	**Equity Method**
Topic	**Purchase of an additional interest in an associate while retaining significant influence**
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Purpose of this paper

1. At its April 2022 meeting, the International Accounting Standards Board (IASB) started to discuss the application question: *How does an investor apply the equity method when purchasing an additional interest in an associate while retaining significant influence?*

2. This agenda paper sets out the IASB discussions in developing the answer to this application question and asks the IASB if there are any further matters it wishes to discuss in relation to the application question.

Staff recommendation

3. The staff recommend the IASB proposes to answer the application question in paragraph 1 of this paper: *An investor purchasing an additional interest in an associate, while retaining significant influence, recognises any difference between the cost of the additional interest and its additional share in the net fair value of the associate's identifiable assets and liabilities as goodwill or as a bargain purchase.*

Structure of this paper

4. This paper is structured as follows:

   (a) background (paragraphs 5–8 of this paper);

   (b) summary of the IASB's discussions (paragraphs 9–32 of this paper);

   (c) questions to the IASB;

   (d) Appendix A—Illustrative example: Applying the preferred approach; and

   (e) Appendix B—Extract from the Conceptual Framework for Financial Reporting (Conceptual Framework).

Background

5. At its April 2022 meeting, the IASB discussed three approaches to answer to the application question in paragraph 1 of this paper and asked the staff to continue exploring one approach (referred to as the 'preferred approach'):

Preferred approach	After obtaining significant influence, an investor measures its additional interests in an associate as an accumulation of purchases. An investor recognises, at the date of purchasing an additional interest, any difference between the cost of the additional interest and its additional share in the net fair value of the associate's identifiable assets and liabilities as goodwill or as a bargain purchase.

6. The IASB also asked the staff to consider the implications of applying a second approach (referred to as the 'alternative approach'):

Alternative approach	After obtaining significant influence, an investor measures its investment in the associate as a single asset. An investor measures its aggregated share of the associate's identifiable assets and liabilities at fair value and remeasures the cost of the investment at fair value at the date of purchasing an additional interest in an associate while retaining significant influence.

7. To develop the preferred approach, the IASB reached a tentative decision on how an investor measures the cost of an investment on obtaining significant influence, when the investor holds a previous interest in the associate (paragraphs 9–15 of this paper).

8. In addition to answering the application question in paragraph 1 of this paper, the IASB also reached tentative decisions on how an investor retaining significant influence would apply the preferred approach:

    (a) when purchasing of an additional interest in associate that is a bargain (June 2022 meeting)[1];

    (b) to other changes in the associate's net assets that change the investor's ownership interest (September 2022 meeting)[2];

    (c) when the investor purchases an additional interest after reducing the carrying amount of its interest to nil (December 2022 meeting)[3]; and

    (d) when disposing of an interest in associate while retaining significant influence (December 2022 meeting)[4].

[1] AP13A: Purchase of an additional interest (and disposal of an interest) in an associate while retaining significant influence (ifrs.org)

[2] AP13B: Changes in an associate's net assets that change the investor's ownership interest (ifrs.org)

[3] AP13b-purchase-of-an-additional-interest-in-an-associate-and-share-of-unrecognised-losses-final.pdf (ifrs.org)

[4] AP13a-applying-the-preferred-approach-after-purchase-date-final.pdf (ifrs.org)

Summary of the IASB's discussions

Measuring the cost of an investment on obtaining significant influence

9. Paragraph 32 of IAS 28 *Investments in Associates and Joint Ventures* requires an investor obtaining significant influence to recognise the difference between the cost of the investment and the investor's share of the associate's net assets as goodwill (or bargain purchase gain), however IAS 28 does not define cost.

10. The IASB decided that the application question in paragraph 1 of this paper may, in part, arise from uncertainty on how to measure the cost of an investment on obtaining significant influence, when the investor holds a previous interest in the associate. The IASB therefore decided to divide the application question into two:

    (a) how to measure the cost of the investment on obtaining significant influence; and

    (b) how to measure the investor's share in the net fair value of the associate's identifiable assets and liabilities, when purchasing an additional interest in an associate while retaining significant influence.

11. The IASB noted that the IFRS Interpretation Committee (Committee) had examined how to measure the cost of an investment in a subsidiary when a parent accounts for investments in subsidiaries at cost in its separate financial statements. The Committee concluded that when the parent holds an interest in an investee that qualifies as a financial instrument in accordance with IFRS 9 *Financial Instruments* and subsequently obtains control of that investee, a reasonable reading of IFRS Accounting Standards could result in the parent using either of the following approaches:

    (a) the consideration paid for the interest (original consideration), plus any consideration paid for the additional interest; or

    (b) the fair value of the interest at the date of obtaining control of the subsidiary, plus any consideration paid for the additional interest.

12. However, the IASB noted that before obtaining significant influence, an investor holding a previous interest in the associate would apply IFRS 9 and measure that interest at fair value.

13. The IASB also noted that paragraph 42 of IFRS 3 *Business Combinations* requires an acquirer to remeasure its previously held equity interests in the acquiree at its acquisition-date fair value, consistent with a reporting entity perspective. When the investor obtains significant influence, the relationship between the investor and the investee, and the accounting method for the investment, changes. The investor exchanges its previously held financial asset with an investment in which it has significant influence and to which the equity method is applied. The fair value of the interest given up at the acquisition date represents part of the consideration paid.

14. In its approach the IASB identified the principles that underlie IAS 28 (see the *Cover Paper* for this meeting). Principle D states:

> Fair value at the date that significant influence or joint control is obtained provides the most relevant information and faithful representation of an associate's or joint venture's identifiable net assets.

15. The IASB tentatively decided to propose the cost of an investment is measured at the fair value of the consideration transferred at the date significant influence is obtained. In reaching this tentative decision the IASB took into consideration:

    (a) measuring the costs of the investment at fair value would be consistent with principle D which measures the associate's identifiable assets at fair value on obtaining significant influence;

    (b) obtaining significant influence changes the relationship between the investor and the investee and thereby the recognition and measurement requirements (that is, the investor applies the equity method of accounting);

    (c) when the investor obtains significant influence, the interest is recognised as a single asset;

(d) measuring the previously held interest at fair value when the investor obtains significant influence is consistent with the requirement in paragraph 22(b) of IAS 28 to measure any retained interest in a former associate at fair value when the investor loses significant influence; and

(e) prior to obtaining significant influence an entity measures the investment at fair value at each reporting date. Measuring the cost of the investment at fair value would not change the measurement requirements for previously held interests and hence there are no additional costs involved for the investor.

Investor's share in the net fair value of the associate's identifiable assets and liabilities when purchasing an additional interest

16. To answer the second part of the application question in paragraph 10 (how to measure the investor's share in the net fair value of the associate's identifiable assets and liabilities, when purchasing an additional interest in an associate while retaining significant influence) the IASB considered the preferred and the alternative approach.

The preferred approach

17. The preferred approach would measure the investor's additional share of the associate's identifiable assets and liabilities at the fair value at the date of purchasing the additional interest. This approach measures the investor's interest in the associate as an accumulation of purchases.

18. In developing principle D, the IASB noted that paragraph 198 of the Basis for Conclusion of IFRS 3 explains that:

> … fair value is the most relevant attributes for assets acquired and liabilities assumed in a business combination. Measurement at fair value provides information that is more comparable and understandable than measurement at cost or on the basis of allocating the total cost of an acquisition.

19. The preferred approach is consistent with principle D and the IASB's views in developing IFRS 3 that fair value provides the most relevant information for assets acquired and liabilities assumed on obtaining significant influence and when the investor obtains an additional interest in the associate without obtaining control.

20. Measuring the investor's additional share of the associate's net assets at fair value provides a faithful representation of the goodwill as the cost of the additional interest will also be measured at fair value. If the carrying amount of the net assets was used, the unrecognised changes in their fair value would be included in the goodwill.

21. Finally, the IASB observed that the preferred approach is consistent with the requirements for the purchase of additional interests in a joint operation in which the activity of the joint operation constitutes a business. Paragraph 21A of IFRS 11 *Joint Arrangements* requires that when an entity acquires an interest in a joint operation in which the activity of the joint operation constitutes a business, it shall apply all of the principles on business combinations accounting in IFRS 3 that do not conflict with the guidance in IFRS 11. These principles include measuring identifiable assets and liabilities at fair value.

Cost and benefits of the preferred approach

22. An IASB member has expressed the view that the effort and costs of measuring an investor's additional share of the associate's identifiable assets and liabilities at the fair value at the date of purchasing the additional interest do not outweigh its benefits. Paragraphs 2.39-2.43 of the *Conceptual Framework* explain how the IASB should apply the cost constraint in developing IFRS Accounting Standards (see Appendix B).

23. In applying the equity method of accounting the difference between the cost of the investment and the investor's share of the net fair value associate's identifiable assets and liabilities is goodwill; which is presented in the single line item for investments in associates. Therefore, using a measurement other than fair value for the investor's additional share of the associate's net assets changes the allocation between goodwill and net assets but not the cost of the investment.

24. Not using fair value risks creating impairment issues in future periods. When assigned to the net assets, fair value adjustments are eliminated over time as the associate sells or depreciates the net assets; but the difference assigned to goodwill is not amortised, and the investor will recognise a higher share of profit or loss. The carrying amount of the investment in the associate will continue exceeding the share in the associate's net assets.

25. In some cases, the difference between fair value and book value of the investor's share in the associate's net assets may not be material; for example if the size of the additional interest is small or there has been a short interval since the purchase of a previous interest. In these circumstances an investor would apply judgment in assessing materiality.

The alternative approach

26. The alternative approach would measure:

    (a) the cost of the investment at fair value at the date of purchasing the additional interest. This would involve remeasuring cost of the investment (that is the previously held interest) at each date of an additional purchase and recognising the gain of loss in comprehensive income.

    (b) the investor's share of the associate identifiable assets and liabilities at fair value at the date of purchasing the additional interest in the associate.

27. The alternative approach would provide fair value information on the investment as a single asset updated at the date of each purchase. The alternative approach provides:

    (a) consistency between the measurement of the cost of the investment and the investors share of the associate's net assets; and

(b) information on the fair value of the investment as a whole, which assists in assessing the investment's expected contribution to future cash flows. Information provided using fair value may have predictive value for the users as the information reflects market participant views. Remeasuring previously held interests and the investor's share of the associate's net assets may also provide confirmatory information as it will provide users with feedback about previous expectations.

28. However, the alternative approach would provide the fair value information only when there is a change in the investor's ownership interest.

29. The IASB noted that remeasuring the cost of the investment and the investor's share of associate's net assets when an investor purchases an additional interest in the associate while retaining significant influence is *not* consistent with paragraph BC384 of the Basis of Conclusion on IFRS 3 for business combinations achieved in stages. Obtaining control is a significant economic event that changes the nature of the investment, but purchasing an additional interest in an associate is not.

30. Furthermore, the IASB noted that IFRS Accounting Standards do not require remeasurement of previously held interest when a transaction does not change the relation between an investor and an investee, or when there is no change in the accounting method applied:

(a) paragraph B33C of IFRS 11 states that a joint operator might increase its interest in a joint operation in which the activity of the joint operation constitutes a business, as defined in IFRS 3, by acquiring an additional interest in the joint operation. In such cases, previously held interests in the joint operation are not remeasured if the joint operator retains joint control.

(b) paragraph 24 of IAS 28 requires that if an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest.

31. It is also noted that many stakeholders support the equity method's carry forward of the cumulative information of post-acquisition recognised changes in assets and liabilities. Remeasuring the previously held interest at each purchase date loses the historical information, as it resets the date of obtaining significant influence.

32. As the IASB continued the analysis of the application questions in paragraph 1 and 8 of this paper the IASB discontinued its discussion of the alternative approach.

Questions to the IASB

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1. Does the IASB agree with the staff recommendation in paragraph 3 of this paper to propose an investor purchasing an additional interest in an associate, while retaining significant influence, recognises any difference between the cost of the additional interest and its additional share in the net fair value of the associate's identifiable assets and liabilities as goodwill or as a bargain purchase. 2. Does the IASB have any comments on the summary in this paper?

Appendix A—Illustrative example: Applying the preferred approach

A1. At 1/1/20X1 Entity A purchases 5% in Entity B. Entity A pays 200CU in cash. At 31/12/20X1 the fair value is 280CU. In accordance with IFRS 9, the entity measures the financial asset at fair value with the changes recognised in profit or loss.

A2. Applying IFRS 9, the accounting entries for the year ending 31/12/20X1 are:

To recognise the financial asset		
Dr Financial assets	200	
Cr Cash		200
To recognise the change in fair value in the period		
Dr Financial assets	80	
Cr Profit or loss		80

Obtaining significant influence

A3. At 1/1/20X2 Entity A purchases an additional 20% and obtains significant influence. The investor pays 1,120CU in cash. The investor starts applying the equity method.

A4. At the date of the purchase, the carrying amount and fair value of the associate's net assets are 4,000CU and 4,400CU respectively. The fair value adjustment is related to an item of property to be depreciated on a residual useful life of 10 years (40CU p.a.).

A5. The associate reports a profit for 20X2 of 840CU. The investor's share of the reported profit is 210CU. The investor adjusts the share of profit to 200CU to depreciate the fair value adjustment (400*25%*10%).

A6. Applying the preferred approach, the accounting entry at 1/1/20X2 is:

To recognise the investment in the associate		
Dr Investment in associate	1,400	
Cr Financial assets		280
Cr Cash		1,120

A7. Applying IAS 28, the accounting entry for the period ending 31/12/20X2 is:

To recognise the investor's share of the associate's profit or loss		
Dr Investment in associate	200	
Cr Profit or loss		200

A8. At 31/12/20X2 the reconciliation of the carrying amount of the associate is:

	Acquisition	**Post-acquisition changes**	**Total**
Share of net assets	1,100	200	1,300
Goodwill	300	-	300
Total	1,400	200	1,600

A9. At 1/1/20X3 there is an increase in the investor's ownership interest. Two alternative scenarios are illustrated:

(a) the investor purchases an additional interest in the associate (paragraphs A10–A13 of this appendix).

(b) another shareholder redeems its shares (paragraphs A14–A17 of this appendix).

Purchase of an additional interest

A10. At 1/1/20X3 the investor purchases an additional 10% in the associate. The investor pays 700CU in cash.

A11. At the date of the purchase of the additional interest, the fair value of the associate's net assets is 5,500CU, and the investor's additional share is 550CU. The difference between 700CU and 550CU is recognised as goodwill.

A12. Applying the preferred approach, the accounting entry for the purchase of the additional interest is:

Dr Investment in associate	700	
Cr Cash		700

A13. The carrying amount of the investment in the associate increases by the fair value of the consideration paid from 1,600CU to 2,300CU. The reconciliation of the carrying amount of the associate is:

	Total
Share of net assets	1,850
Goodwill	450
Total	2,300

Redemption

A14. At 1/1/20X3, a shareholder that owns a 10% interest in the associate redeems its shares at their fair value.

A15. Before the redemption, the carrying amount and fair value of the associate's net assets is 5,200CU and 5,500CU respectively. The associate pays 700CU to redeem the shares. The investor's ownership interest in the associate changes from 25% to (25/90) = 27.8%.

A16. Applying the preferred approach, the carrying amount of the investment does not change. The investor measures the share in the associate's net assets as:

		Share	Total
Carrying amount of net assets, less redemption amount	(5,200-700) 4,500	25.0%	1,125
Fair value of net assets, less redemption amount	(5,500-700) 4,800	2.8%	133
Total		27.8%	1,258

A17. The reconciliation of the carrying amount of the associate is:

	Total
Share of net assets	1,258
Goodwill	342
Total	1,600

Appendix B—Extract from the *Conceptual Framework*

B1. The following extracts explain the cost constraint on useful financial reporting.

> 2.39 Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.
>
> 2.40 Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analysing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.
>
> 2.41 Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender or other creditor also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.
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> 2.42 In applying the cost constraint, the Board assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in developing a proposed Standard, the Board seeks information from providers of financial information, users, auditors, academics and others about the expected nature and quantity of the benefits and costs of that Standard. In most situations, assessments are based on a combination of quantitative and qualitative information.
>
> 2.43 Because of the inherent subjectivity, different individuals' assessments of the costs and benefits of reporting particular items of financial information will vary. Therefore, the Board seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities. That does not mean that assessments of costs and benefits always justify the same reporting requirements for all entities. Differences may be appropriate because of different sizes of entities, different ways of raising capital (publicly or privately), different users' needs or other factors.