IFRS Accounting

Staff paper

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Project	**Equity Method**
Topic	**Towards an Exposure Draft—Clarifications to the IASB's tentative decisions**
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Introduction and purpose of this paper

1. At its meeting in November 2023, the International Accounting Standards Board (IASB) completed its technical discussions on the application questions in the scope of the Equity Method project. The Equity Method project objective is to develop answers to application questions on the equity method, as set out in IAS 28 *Investments in Associates and Joint Ventures*, using the principles derived from IAS 28 where possible. Agenda paper 13 *Cover Paper* of this meeting provides a summary of the IASB's tentative decisions in the project.

2. The purpose of this paper is to ask the IASB to clarify several matters arising from its tentative decisions and decide whether to propose amendments to IFRS Accounting Standards.

The International Accounting Standards Board is an independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRS Standards. For more information visit www.ifrs.org.

Staff recommendation

3. The staff recommend the IASB:

   (a) to clarify that if a parent entity has elected to use the equity method to account for its investments in subsidiaries in its separate financial statements, the parent applies paragraph 24 of IAS 28 to a step acquisition of a subsidiary (that is, the parent entity does not remeasure the previously held interest to which it has applied the equity method).

   (b) to retain the project's scope, by not adding the application questions:

      (i) *how should a parent entity measure the cost of its investment in a subsidiary acquired in stages and accounted for at cost in separate financial statements?*

      (ii) *how does an entity recognise the acquisition-related cost for investments to which the entity applies the equity method of accounting?*

   (c) to clarify that an investor or a joint venturer applies the IASB's tentative decisions to contingent consideration arrangements and deferred taxes when it purchases an additional interest in an associate or a joint venture.

   (d) to amend paragraph 10 of IAS 28 to refer to *changes in the investor's share in the associate's net assets.*

Structure of this paper

4. This paper is structured as follows:

   (a) investment in subsidiaries accounted for using the equity method—step acquisition (paragraphs 5–24 of this paper);

   (b) investment in subsidiaries measured at cost—step acquisition (paragraphs 25–35 of this paper);

   (c) acquisition-related costs (paragraphs 36–45 of this paper);

(d) contingent consideration and deferred taxes on purchase of additional interests (paragraphs 46–51 of this paper);

(e) paragraph 10 of IAS 28 (paragraphs 52–57 of this paper); and

(f) question for the IASB.

Investment in subsidiaries accounted for using the equity method—step acquisition

5. Paragraphs 7–24 of this paper set out the staff analysis on how a parent entity would measure the cost of an investment in a subsidiary in its separate financial statements in this fact pattern:

   (a) the parent held an equity interest in the subsidiary prior to obtaining control;

   (b) the previously held interest is an associate or joint venture; and

   (c) the parent has elected to apply the equity method to its investments both in associates and subsidiaries in its separate financial statements.

6. In the fact pattern the parent entity applies the equity method to the investment before and after obtaining control.

7. The staff think the IASB should consider how its tentative decisions in this project would apply in the fact pattern in paragraphs 5–6 of this paper, that is, *how does the parent entity measure the cost of the subsidiary when it has applied the equity method to previously held interests in that subsidiary*.

Requirements in consolidated financial statements – subsidiaries

8. Paragraphs 41–42 of IFRS 3 *Business Combinations* set out requirements for an acquirer obtaining control of an acquiree, in which the acquirer holds an equity interest immediately before the acquisition date. IFRS 3 requires the acquirer to measure the 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. Consequently, if the previously held interest is an associate or joint venture to which the acquirer applied the equity method before obtaining control, the acquirer recognises a gain or loss on the remeasurement of the previously held interest in accordance with paragraph 42 of IFRS 3.

Consolidated financial statements – associates and joint ventures

9. IAS 28 does not specify how an entity measures the cost of an investment in an associate acquired in a step acquisition. In a step acquisition of an associate, the previously held equity interest is an equity instrument in the scope of IFRS 9 *Financial Instruments*. IFRS 9 requires an entity to measure equity instruments at fair value.

10. In April 2022, the IASB tentatively decided to propose that an investor, on obtaining significant influence, measures the cost of an investment at the fair value of the consideration transferred, including the fair value of any previously held interest in the associate. The IASB's tentative decision is aligned with the requirements in IFRS 3 for business combinations achieved in stages.

11. In October 2023, the IASB tentatively decided that its tentative decisions on application questions for investments in associates also apply when a parent elects to apply the equity method in its separate financial statements to investments in subsidiaries.

Information on accounting practices

12. In October 2023 the IASB discussed informal feedback from outreach with national standard-setters and regional bodies from jurisdictions where parent entities prepare separate financial statements and use the equity method in separate financial statements.[1]

13. The feedback did not provide evidence that using the equity method in separate financial statements for investments in subsidiaries is widespread amongst jurisdictions. Among jurisdictions in which the method is used, there is a divergence in practice on how parent entities apply the equity method in separate financial statements for investments in subsidiaries. For example:

    (a) some parent entities apply the equity method as set out in IAS 28 which uses the same principles for investments in associates.

    (b) some parent entities apply the equity method by analogising to IFRS 3 and IFRS 10 *Consolidated Financial Statements*, in which the parent and its subsidiaries are accounted for as one economic entity in the parent's separate financial statements. Some entities in this group aim to align the carrying amount of its investment in a subsidiary in the parent's separate financial statements with the net assets of the subsidiary attributable to the parent as in the parent's consolidated financial statements, whereas other entities aim to align amounts reported in the shareholder's equity in the parent's separate financial statements, with the equity attributable to the owners of the parent in consolidated financial statements.

    (c) some parent entities apply a combination of the approaches in subparagraphs (a) and (b).

[1] For more detail see Agenda Paper 13A Implications of applying the IASB's tentative decisions to investments in subsidiaries in separate financial statements for the September 2023 meeting.

Staff analysis

14. The feedback suggests that entities use various approaches to measure the cost of a subsidiary in the fact pattern described in paragraph 5 of this paper. Consequently, clarifying how an entity is required to measure the costs of a subsidiary in separate financial statements when using the equity method is likely to affect practice.

15. The proposed amendments will add a definition of the cost of the investment to IAS 28, consequently the staff think, in the fact pattern described in paragraph 5 of this paper, a parent entity would apply the added definition of cost of the investment to a step acquisition of a subsidiary.

16. Applying the IASB's tentative decision described in paragraphs 10–11 of this paper, a parent entity would measure the cost of the subsidiary in the separate financial statements at the fair value of the consideration transferred, including the fair value of any previously held interest. Therefore, the parent entity would remeasure the previously held interest and recognise a gain or loss and measure the cost of the investment in the subsidiary in the parent's separate financial statement consistently with the measurement of that subsidiary in consolidated financial statements. However, in this fact pattern the parent entity would apply the equity method both before and after obtaining control.

17. The staff note that IFRS 3 explains the use of fair value for the previously held interest as: on obtaining control, the acquirer exchanges its status as an owner of an investment for a controlling financial interest in all the underlying assets and liabilities of the acquiree. This change warrants a change in the classification and measurement of the investment.

18. However, IAS 27 *Separate Financial Statements* explains the distinction between accounting for subsidiaries as equity investment in the parent's separate financial statements and as the economic entity that the parent controls in the consolidated financial statements. Agenda Paper 13A *Towards an Exposure Draft—Implications of applying the IASB's tentative decisions to investments in subsidiaries in separate financial statements* for the October 2023 IASB meeting acknowledges that consolidated and separate financial statements are intended to provide different information in relation to investments.

19. It could be argued that if the measurement of the cost of investment does not change (as in the fact pattern described in paragraph 5 of this paper) there is no basis to require remeasurement of the previously held interest. The IASB used this same argument to explain the requirement in paragraph 24 of IAS 28—that is, if an investment in an associate becomes an investment in a joint venture or vice versa, the entity is not required to remeasure the retained interest.

20. The staff think the IASB should clarify how a parent entity measures the cost of the subsidiary when it has applied the equity method to previously held interests in the subsidiary. As noted, if the IASB does not clarify this matter the parent entity will remeasure its previously held interests that are accounted for using the equity method both before and after obtaining control.

21. The list of application questions the IASB has decided to include in the project did not include this question—the question arises because of the IASB's tentative decision on the measurement of the cost of the subsidiary in the fact pattern described in paragraph 5 of this paper.

22. The staff think the IASB could in the future exposure draft on IAS 28 Amended:

    (a) clarify that its April 2022 tentative decision applies to any step acquisition of a subsidiary thereby requiring an entity to remeasure previously held interests; or

(b) propose an entity measure the cost of the subsidiary in the fact pattern described in paragraph 5 in accordance with paragraph 24 of IAS 28 thereby not requiring an entity to remeasure the previously held interests.

23. Both of the alternatives in paragraph 22 of this paper are likely to affect current practice. On balance, the staff recommend the alternative in paragraph 22(b). We think that the choice ensures consistency with the requirements and IASB's tentative decision applicable to other fact patterns in which the entity applies the equity method before and after the transaction (change from significant influence to joint control, purchase of an additional interest or partial disposal).

24. However, if the IASB decides it would prefer not to affect current practice (because separate financial statements are often linked to the distribution of income and local requirements related to financial reporting) we think the IASB should propose an amendment to IAS 27 to allow an accounting policy option between the two alternatives in paragraph 22.

Investment in subsidiaries measured at cost—step acquisition

25. The discussion in paragraphs 5–24 of this paper refers to the measurement of the cost (on obtaining control) of subsidiaries acquired in stages and accounted for using the equity method in the separate financial statements. A similar discussion could apply on how a parent entity measures the cost of an investment in a subsidiary in its separate financial statements in this fact pattern:

(a) the parent held an equity interest in the subsidiary prior to obtaining control;

(b) the previously held interest is an equity instrument and measured in accordance with IFRS 9; and

(c) the parent has elected to apply the **cost method** to its investments in subsidiaries in its separate financial statements.

26. The question is whether the parent entity would include in the cost of the investment in the subsidiary the fair value of the previously held interest or the historical cost.

27. Paragraphs 28–35 of this paper discuss whether the IASB should amend the scope of the project to include the question: *How should a parent entity measure the cost of its investment in a subsidiary acquired in stages and accounted for at cost in separate financial statements?*

IFRIC Agenda Decision

28. IAS 27 does not define cost of an investment in a subsidiary if the subsidiary is measured at cost in separate financial statements. In September 2018 the IFRS Interpretations Committee (Committee) examined the question in the fact pattern described in paragraph 25 of this paper.

29. In Agenda Paper 6B *IAS 27–Investment in a subsidiary accounted for at cost: Step acquisition* from the September 2018 Committee meeting, the staff noted that:

    (a) the step acquisition transaction is not common in some jurisdictions, particularly jurisdictions in which entities are either not required to prepare separate financial statements or do not apply IFRS Accounting Standards to separate financial statements. However, the transaction does occur more than infrequently in some jurisdictions.

    (b) the outreach findings indicate that entities apply various approaches to determine the cost of an investment in a subsidiary acquired in stages in separate financial statements.

30. The Committee concluded that IAS 27 does not have a definition of cost and that when a parent holds an interest in an investee that qualifies as a financial instrument in accordance with IFRS 9 and subsequently obtains control of that investee, a reasonable reading of IFRS Accounting Standards could result in the parent applying either of the following approaches:[2]

    (a) the consideration paid for the interest (original consideration), plus any consideration paid for the additional interest (accumulated cost approach); 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 (fair value as deemed cost approach).

31. The Committee agreed not to add the matter to its agenda, because:

    (a) it did not have evidence to assess whether the application of the two acceptable approaches to determining cost, outlined in this agenda decision, would have a material effect on those affected; and

    (b) amending IAS 27 would not be possible without considering the implications for IAS 28 and the issue could be added to the Equity Method project (which at that date was not yet active).

Staff analysis

32. The staff accept that the questions in paragraphs 7 and 27 of this paper share similarities because they both refer to the initial measurement of a subsidiary acquired in stages. That said, the question in paragraph 27 is not directly related to the application of the equity method and is not included in the scope of the project. However, the IASB added application questions to the project's scope when its tentative decisions provided a solution and no further work was needed to answer the question.

[2] January 2019 Agenda Decision IAS 27 *Separate Financial Statements*–Investment in a subsidiary accounted for at cost: Step acquisition.

33. The IASB could expand its tentative decision in paragraph 10 to provide a valid solution that is immediately applicable. If so in the fact pattern in paragraph 25, a parent would be required to measure cost of the subsidiary at the fair value at the date control is obtained.

34. However, the staff think that several arguments support not adding the question in paragraph 27 to the scope of the project:

    (a) we have limited information on the effect of requiring an approach, including legal and tax consequences, given the role of separate financial statements are used in some jurisdictions;

    (b) there is a risk of 'scope creep' because of the other fact patterns for step acquisitions of a subsidiary measured at cost (for instance the previously held interest qualifies as an associate or joint venture, to which the parent applies a different accounting method);

    (c) IAS 27 allows entities to choose between subsequent measurements. Aligning the initial measurement of the cost of the investment might not be a significant improvement; and

    (d) although the Committee could not answer the question, entities can use the January 2019 Agenda Decision as a basis to develop their own accounting policy.

35. Based on the arguments in paragraph 34, the staff recommend the IASB not add the question in paragraph 27 of this paper to the scope of the project.

Acquisition-related costs

36. The IASB's tentative decision to define how to measure the cost of an investment in an associate or joint venture does not specify how to recognise acquisition-related costs–that is, whether they should be recognised as part of the cost of the investment or recognised in profit and loss as incurred. Neither IAS 27 nor IAS 28 include requirements on acquisition-related costs.

37. Paragraphs 38 to 45 of this paper consider whether the IASB should amend the scope of the project to include the question: *How does an entity recognise the acquisition-related cost for investments to which the entity applies the equity method of accounting?*

38. The Committee considered this question at its May 2009 meeting, when it discussed how an entity should determine the initial carrying amount of an equity method investment.[3] The Committee discussion occurred after the IASB changed the requirements for acquisition-related costs in a business combination when it issued a revised version of IFRS 3 in 2008.

39. Paragraph 53 of IFRS 3 requires the acquirer to recognise acquisition-related costs as expenses in the period in which they are incurred (with one exception for the costs to issue debt or equity securities). Paragraph BC366 of the Basis for Conclusions on IFRS 3 explains that acquisition-related costs are not part of the fair value exchange between the acquirer and the buyer and are separate transactions for services received.

40. The staff agenda paper supporting the Committee's discussion observed some constituents were analogising to the requirements in IFRS 3 (2004) to account for acquisition-related costs on investments in associates as well as for investments in subsidiaries in separate financial statements. It was unclear whether the changes introduced by IFRS 3 (2008) should also apply to these categories of investment.

[3] July 2009 Agenda Decision IAS 28 *Investment in Associates* Potential effect of IFRS 3 and IAS 27 on equity method accounting.

41. The Committee noted that IFRSs Accounting Standards consistently require an entity to measure at initial recognition assets that are not measured at fair value through profit or loss at cost instead. Generally stated, cost includes the purchase price and other costs directly attributable to the acquisition or issuance of the asset, such as professional fees for legal services, transfer taxes and other transaction costs. Therefore, the cost of an investment in associate at initial recognition comprises its purchase price and any directly attributable expenditures necessary to obtain it.

42. The Committee concluded that given the guidance in IFRS Accounting Standards, it did not expect varied interpretations in practice and decided not to add this issue to its agenda.

Project scope—do the IASB tentative decisions apply?

43. To assess whether to add this topic to the project scope, the staff considered whether the IASB's tentative decision could be applied without further work. We do not think that a 'ready-made tentative decision' in the project exists that would automatically answer this application question. Furthermore:

    (a) the purpose of the project is to develop answers to application questions on applying the equity method. We reviewed the initial input from constituents and did not find questions about how to recognise acquisition-related costs, possibly because of the May 2009 Agenda Decision.

    (b) none of the principles identified as underlying IAS 28 would provide a basis to develop a solution to the question.

    (c) the IASB could receive further requests on the question of acquisition-related costs for other investments in IAS 27, including investments accounted for at cost, if it expands the scope of the project.

44. The staff also looked at IFRS Accounting Standards to see if it is possible to identify a 'quick' answer. However, the requirements are not aligned because:

(a) paragraph 26 of IAS 28 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 joint venture. The IASB relied on this analogy, for example, when it made its tentative decision on contingent consideration on the purchase of an associate or joint venture. A similar application by analogy would support recognising costs related to the acquisition of an investment in an associate or joint venture as expenses;

(b) the Basis for Conclusions on IAS 27 explains that in separate financial statements, a parent accounts for investments in subsidiaries as equity investments. In IFRS 9, an entity measures equity instruments at fair value and either recognises the changes in fair value in profit or loss or presents the changes in other comprehensive income. IFRS 9 requires transaction costs to be included in the initial measurement of financial assets other than those at fair value through profit or loss. Paragraph E.1.1 of the *Guidance on implementing IFRS 9* explains that for financial instruments for which the entity decides to make an irrevocable election to present changes in fair value in other comprehensive income, the entity then recognises transaction costs in other comprehensive income as part of the change in fair value at the next remeasurement;

(c) paragraph 10 of IAS 28 states that using the equity method, on initial recognition an entity recognises the investment in an associate or joint venture at cost. Paragraph 6.5 of the *Conceptual Framework for Financial Reporting* states that the historical cost of an asset comprises the consideration paid to acquire or create the asset *plus transaction costs*.

(d) when the Committee discussed the issue, it concluded that the requirements in IAS 28 did not need to be aligned to the requirements in IFRS 3 for the reasons explained in paragraph 41 of this paper.

45. The staff analysis did not identify a 'ready-made tentative decision' or 'a quick' analogy in IFRS Accounting Standards. Based on the analysis presented in paragraphs 36 to 44 of this paper, the staff recommend the IASB not amend the scope of the project to propose requirements on the recognition of acquisition-related costs for investments to which an entity applies the equity method of accounting.

Contingent consideration and deferred taxes on purchase of additional interests

46. At its April 2023 meeting, the IASB tentatively decided that an investor would account for and include in the carrying amount of its investment in an associate, a deferred tax asset (or liability) arising from recognising as part of the cost of the investment its share of the associate's net identifiable assets and liabilities at fair value in accordance with paragraph 32 of IAS 28.

47. At its June 2023 meeting, the IASB tentatively decided that on acquisition of an investment in an associate or joint venture, an investor recognises contingent consideration as part of the cost of the investment and measures that contingent consideration at fair value.

48. The IASB discussed these tentative decisions in relation to the acquisition of an interest in an associate or joint venture, that is, when the entity obtains significant influence or joint control.

49. The staff has been asked if the IASB intended the tentative decisions in paragraphs 46– 47 of this paper to apply when an investor purchases an additional interest in the associate or joint venture.

50. To respond to this question the staff considered the IASB's tentative decisions, including:

    (a) the March 2023 tentative decision, when the IASB confirmed its tentative decision to propose that 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 either as goodwill, or as a gain from a bargain purchase;[4]

    (b) the tentative decision discussed in Agenda Paper 13D *Initial recognition of an investment in an associate–deferred taxes* of the March 2023 IASB meeting, which states that accounting for deferred tax assets and liabilities is a consequence of measuring the entity's share in the investee's net assets at fair value at the date the interest is acquired; and

    (c) the tentative decision discussed in Agenda Paper 13B *Towards an Exposure Draft—Contingent consideration on acquisition of an investment in an associate, including subsequent measurement* of the June 2023 IASB meeting, which states that recognising and measuring contingent consideration at fair value provides relevant information on the future cashflows of the investor.

51. Based on this analysis, the staff think that the IASB tentative decisions in paragraphs 46–47 of this paper apply to the purchase of an additional interest. Consequently, the staff recommend the IASB clarifies, while drafting the exposure draft, that an investor applies these tentative decisions when it purchases an additional interest in an associate or joint venture.

[4] For more detail, see Agenda Paper 13A *Purchase of an additional interest in an associate while retaining significant influence* for the March 2023 IASB meeting.

Paragraph 10 of IAS 28

52. Paragraph 3 of IAS 28 defines the equity method as "a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the **post-acquisition change in the investor's share of the investee's net assets**". However, (following a consequential amendment to IAS 28 made as part of the 2007 revision to IAS 1 *Presentation of Financial Statements*) paragraph 10 of IAS 28 only refers to the **investor's share of the investee's profit or loss and other comprehensive income**, and distributions received and does not state whether, and if so, where the investor should account for its share of the associate's other net asset changes. Consequentially, some view paragraphs 3 and 10 of IAS 28 as being inconsistent with each other, or at least unclear.

53. In November 2012, the IASB published the Exposure Draft *Equity Method: Share of Other Net Asset Changes* (Proposed amendments to IAS 28) that would have provided a solution to the perceived inconsistency. The IASB had proposed to require an investor to:

    (a) recognise, in the investor's equity, the other changes in the investor's share of the investee's net assets; and

    (b) reclassify to profit or loss the cumulative amount of those other changes previously recognised in equity, when the investor discontinues the use of the equity method.

    However, at its May 2014 meeting the IASB decided not to proceed with the proposed amendments.

54. At its September 2022 meeting, the IASB tentatively decided that when the investor's ownership interest:

    (a) increases and the investor retains significant influence, the investor would recognise that increase as a purchase of an additional interest;

(b) decreases and the investor retains significant influence, the investor would recognise that decrease as a partial disposal.

55. At its June 2023 meeting, the IASB tentatively decided not to develop proposals on how an investor applies the equity method when an associate grants an equity-settled share-based payment or a share warrant.

56. Following the September 2022 tentative decision, the IASB will propose a clarification in the exposure draft of the presentation of an investor share of the associate's other net asset changes. Therefore, the staff think the wording in paragraph 10 of IAS 28 should be made consistent with the definition of the equity method in paragraph 3 of IAS 28, removing the view that the two paragraphs are inconsistent.

57. The staff recommend the IASB proposes to amend paragraph 10 of IAS 28 so that it refers to the changes in the investor's share in the associate's net assets, and not only to the investor's share of profit or loss, other comprehensive income and distributions.

Question for the IASB

Question for the IASB

1. Does the IASB agree with the staff recommendations in paragraph 3 of this paper:
   - (a) to clarify that if a parent entity has elected to use the equity method to account for its investments in subsidiaries in its separate financial statements, the parent applies paragraph 24 of IAS 28 to a step acquisition of a subsidiary (that is, the parent entity does not remeasure the previously held interest to which it has applied the equity method).
   - (b) to retain the project's scope, not adding the application questions:
     - (i) *how should a parent entity measure the cost of its investment in a subsidiary acquired in stages and accounted for at cost in separate financial statements?*
     - (ii) *how does an entity recognise the acquisition-related cost for investments to which the entity applies the equity method of accounting?*

Question for the IASB

(c) to clarify that an investor or a joint venturer applies the IASB's tentative decisions to contingent consideration arrangements and deferred taxes when it purchases an additional interest in an associate or joint venture.

(d) to amend paragraph 10 of IAS 28 to refer to *changes in the investor's share in the associate's net assets.*