IFRS Accounting

Staff paper

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IASB® meeting

Date	**December 2022**
Project	**Equity Method research project**
Topic	**Applying the preferred approach after the purchase of an additional interest in an associate**
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Purpose of the paper

1. The purpose of this paper is to ask the International Accounting Standards Board (IASB) how an investor would apply the 'preferred approach' after the purchase of an additional interest in an associate while retaining significant influence.

2. The paper analyses how an investor would apply the IASB's preferred approach to transactions and other events after an investor has obtained significant influence.

3. The purpose of the analysis is to explain the staff's recommendation on how an investor would measure the portion of the carrying amount of the investment in the associate to be derecognised on a partial disposal, that is the disposal of an interest in an associate while retaining significant influence.

4. The project's scope does not include application questions on how an investor measures its share of the associates profit or loss, or the level at which the investor assesses impairment of an associate, accordingly the paper does not include recommendations on these topics.

Structure of the paper

5. The paper is structured as follows:

   (a) description of the IASB's preferred approach;

   (b) two views of the investment in an associate;

   (c) staff analysis and recommendation; and

   (d) question to the IASB.

Description of the IASB's preferred approach

6. At its April 2022 meeting, the IASB discussed the application question: *How does an investor apply the equity method when purchasing an additional interest in an associate while retaining significant influence.*

7. The IASB discussed possible approaches to the application question and expressed a preference for an approach (the preferred approach) whereby after obtaining significant influence, an investor measures purchases of an additional interests in an associate as an accumulation of purchases. Applying the preferred approach, the investor:

   (a) recognises, at the date of purchasing an additional interest, its additional share in the fair value of the associate's net assets;

   (b) measures the cost of that additional interest at the fair value of the consideration transferred; and

   (c) recognises the difference between (a) and (b) as a goodwill or bargain purchase gain.

8. The following example illustrates the preferred approach. Assume:

   (a) at 1/1/20X1 entity E purchases 25% of associate A and obtains significant influence. Entity E pays 800CU. The fair value of associate A's net assets is 2,000CU, and the investor's share is 500CU;

   (b) the associate's profit for the period ending 31/12/20X1 is 400CU;

   (c) the carrying amount of the associate's net assets at 31/12/20X1 is 2,400CU. The investor's share of net assets is 2,400CU * 25% = 600CU; and

   (d) at 1/1/20X2 entity E purchases an additional interest of 10%. Entity E pays 500CU. The fair value of associate A's net assets is 2,700CU. The investor's share for the additional interest is 2,700CU * 10% = 270CU.

9. Applying the preferred approach, the investor measures its investment at 1/1/20X2 as follows:

	Purchase of 25%			Purchase of 10%	Aggregate
	1/1/20X1 CU	Profit in 20X1 CU	1/1/20X2 CU	CU	CU
Share of net assets	500	100	600	270	870
Goodwill	300	-	300	230	530
Carrying amount	**800**	**100**	**900**	**500**	**1,400**

10. Applying the preferred approach, the investor measures its share of the associate's net assets at fair value on obtaining significant influence and then at each purchase date. In previous IASB agenda papers, the preferred approach has been described as creating 'layers'.

11. At its June 2022 meeting, the IASB discussed how an investor applies the preferred approach to a disposal of an interest in an associate whilst retaining significant influence (partial disposal) and other changes in the investor's ownership interest.

12. The staff recommended that for a partial disposal an investor retains the layers (see paragraph 10 of this paper) for subsequent measurement and derecognition. Some IASB members said retaining the layers does not represent how the investment is managed and introduces unnecessary complexity to applying the equity method of accounting.

13. The IASB asked the staff to develop an analysis of how the investor would apply the preferred approach from obtaining significant until the equity method is discontinued. During that period, an investor could be required to:

    (a) recognise its share of the associate's changes in net assets[1] including:

        (i) share of the associate's profit or loss;

        (ii) share of the associate's other comprehensive income [2]; and

        (iii) distributions received from the associate;

    (b) recognise an impairment loss; and

    (c) recognise and measure a partial disposal.

14. If an investor loses significant influence of an associate, the investor discontinues applying the equity method and applies IFRS 9 *Financial Instruments* to any retained investment.

Two views of the investment in an associate

15. The paper considers two views of the investment in an associate:

    (a) View A is that the investor is measuring a single investment in the associate. The cost of the investment is measured as an accumulation of purchases after obtaining significant influence. Any portion of the investment is measured as a proportion of the total investment in the associate.

[1] Paragraph 3 of IAS 28 *Investments in Associates and Joint Ventures*.
[2] Paragraph 10 of IAS 28 *Investments in Associates and Joint Ventures*.

(b) View B is that the investor is measuring the layers of the investment in the associate. The investor applies the equity method of accounting to each layer therefore the monetary amounts for each layer are different and not proportionate to the total investment in the associate. After initial recognition on obtaining significant influence and for each additional purchase of an interest in an associate, the investor measures the individual layers separately while presenting them as a single amount in the statement of financial position.

16. View A and View B have the same measurement on initial recognition, that is on obtaining significant influence and for additional purchases of an interest in an associate. In the example in paragraph 8 of this paper, for both View A and View B the carrying amount of the investment would be 1,400CU.

View A – subsequent measurement

Share of profit or loss

17. Applying View A, an investor measures its share of the associate's profit or loss as a proportion of the total profit or loss of the associate.

18. Paragraph 32 of IAS 28 requires that appropriate adjustments are made to the investor's share of the associate's profit or loss in order to account, for example, for depreciation of the depreciable assets based on their fair values on acquisition date (fair value adjustments). Applying paragraph 32 an investor would adjust the associate's profit of loss for fair value adjustments and then recognise its share of the associate's profit or loss.

19. The investor would measure the fair value adjustments to the associate's profit or loss based on the difference between the fair value and carrying amounts in the associate's financial statements on obtaining significant influence and for each additional purchase on an interest in the associate. However, the adjustments are not separately allocated to different layers of the investment.

Distributions received

20. Paragraph 10 of IAS 28 requires an investor to reduce the carrying amount of the investment for the distributions received, such as dividends. The application of the requirement is not affected by applying either View A or View B.

Impairment losses

21. Paragraph 42 of IAS 28 requires an investor to test for impairment the entire carrying amount of the investment by applying the requirements in IAS 36 *Impairment of Assets*. Paragraph 43 of IAS 28 further states that the recoverable amount of an investment in associate shall be assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the entity.

22. The requirements to assess impairment apply at a level that cannot be lower than the net investment. The impairment assessment is not made for parts of the investment.

23. The staff considers that View A is aligned with the requirements in IAS 28 and IAS 36 because it reflects the view that the investor measures the associate as a single investment.

Derecognition in a partial disposal

24. In a partial disposal, an investor would:

    (a) recognise the fair value of the consideration received;

    (b) derecognise a portion of the carrying amount of its investment in the associate;

    (c) recognise the difference between (a) and (b) as a disposal gain or loss; and

    (d) reclassify a proportion of amounts recognised in other comprehensive income to profit or loss (paragraph 25 of IAS 28).

25. Applying View A an investor would not allocate the fair value adjustments to the associate's profit or loss to different layers of the investment and therefore any part disposed of is measured as a proportion of the carrying amount of the investment in the associate.

View B – subsequent measurement

Share of profit or loss

26. Applying View B, an investor would measure each layer of its investment in the associate and thereby recognise its share of the associate's profit or loss on each layer of the investment. Therefore, applying paragraph 32 of IAS 28, the investor would allocate the fair value adjustments to each layer of the investment.

27. In the example in paragraph 8 of this paper, the investor would recognise:

    (a) its share of profit or loss on the layer of the investment that it obtained a significant influence on (25%), adjusting that share of its profit or loss based on the carrying amount of the net assets of 2,400CU; plus

    (b) its share of profit or loss on the additional purchased interest in the associate of 10%, adjusting that share of its profit or loss based on the fair value of the net assets of 2,700CU.

28. The outcome would be the same as in View A, but the investor needs to maintain information on each layer of the investment.

Distribution received

29. As noted in paragraph 20 of this paper, the application of the requirements for recognition of distributions is not affected by applying either View A or View B.

Impairment losses

30. Some may argue applying View B would require replacing the impairment requirements in IAS 28 with a separate impairment assessment for each layer of the investment. This view would argue there should be consistency between how an investor measures its share of the associates profit or loss and impairment as both provide information on the performance of the associate.

31. A separate impairment assessment could lead to recognising an impairment loss on one layer of the investment, whilst not recognising an impairment loss on another layer of the investment. This is because an impairment loss is defined in IAS 36 as the amount by which the carrying amount of an asset exceeds its recoverable amount. Applying View B, even if the carrying amount of the total investment exceeds its recoverable amount, this may not be the case for each individual layer because:

    (a) the recoverable amount of each layer would normally be proportionate to the total recoverable amount of the investment (assuming that the instruments held in the investment in the associate all have the same economic rights); but

    (b) the carrying amount of each layer is not proportionate to the carrying amount of the investment.

32. In the example in paragraph 8 of this paper, the recoverable amount of the additional interest of 10% would be (10/35) = 29% of the recoverable amount of the investment but its carrying amount at 1/1/20X2 is (500/1,400) = 36% of the carrying amount of the investment.

33. IFRS Accounting Standards are different in establishing the level at which impairment is assessed. For example, IAS 16 *Property, Plant and Equipment* requires that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately; whereas IAS 36 requires determining the recoverable amount for an individual asset or the cash-generating unit to which the asset belongs.

Derecognition in a partial disposal

34. Applying View B, an investor would measure the portion of the carrying amount to be derecognised in a partial disposal using a specific allocation method or a cost formula such as last-in, last-out (LIFO).

35. The choice of allocation method affects the disposal gain or loss; assuming the value of the investment has increased, a last-in first-out method would measure a lower gain than a weighted average cost method.

Staff analysis and recommendation

Unit of account

Conceptual Framework

36. Paragraph 4.48 of the *Conceptual Framework for Financial Reporting (Conceptual Framework)* defines the unit of account as the right or group of rights, obligation or groups of obligations, or group of rights and obligations to which the recognition criteria and measurement concepts are applied.

37. Paragraph 4.51 of the *Conceptual Framework* sets out principles to select the unit of account. The information provided must be relevant and faithfully represent the substance of the transaction. Information is for example relevant when the rights have similar economic characteristics and risks and hence are likely to have similar implications for the prospects for future cash flows.

38. Paragraph 4.52 of the *Conceptual Framework* states that cost constrains may affect the selection of a unit of account and notes that in general, the costs associated increase as the size of the unit of account decreases. Hence in general rights or obligations arising from the same source are separated only if the resulting information is more useful and the benefits outweigh the cost.

Requirements in IAS 28

39. IAS 28 does not define the unit of account for the investment in the associate. The analysis of the requirements suggests that there may be different units of account:

    (a) the proportion of an associate allocated to the investor includes the current ownership interest plus potential voting rights and other derivative instruments that currently give the investor access to the returns associated with an ownership interest[3];

    (b) the interest to which the investor's share of loss is allocated, includes the interest in (a) plus any long-term interest that in substance form part of the entity's net investment in an associate[4]. An investor also applies IAS 36 impairment requirements to the net investment, after applying the impairment requirements in IFRS 9 to financial instruments to which the equity method is not applied[5].

Principles underlying IAS 28

40. At its June 2021 meeting, the IASB discussed the principles identified as underlying the requirements in IAS 28. The principles aim to provide the IASB with a toolkit that can help in analysing the application questions and develop solutions.

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[3] See paragraph 13 of IAS 28.
[4] See paragraph 38 of IAS 28.
[5] See paragraph 14A of IAS 28.

41. The staff considered two principles are relevant to determine if View A or View B should prevail:

Principle B – Application of the equity method includes an investor's share in the associate's or joint venture's net asset changes in an investor's statement of financial position; and

Principle E – An investor recognises changes in an associate's or joint venture's net assets. An investor recognises the share of changes in net assets that it can currently access.

42. These principles explain an investor recognises its share of changes in the associate's net assets for the total investment and suggest that the amount is determined for the investment as a whole and not separately for each layer. The staff thinks View A is more consistent with the principles.

Applying the qualitative characteristics to the two views

43. At its June 2022 meeting, IASB tentatively decided an investor measures the portion of the carrying amount to be derecognised in a partial disposal using a specific identification method, if the investor can identify the specific portion of the investment being disposed of; and the LIFO method if the specific portion of the investment being disposed of cannot be identified. The IASB also decided to explore practical methods, concerned about the costs associated with the tentative decision.

44. The staff thinks to respond to the IASB's request it should decide if View A or View B provides more useful information about an investment in an associate.

45. As noted in the analysis, the investor would recognise the same amounts under either view, with the exception of the measurement of a partial disposal gain or loss and possibly impairment losses. Therefore, information provided under View A and View B would in most circumstances have the same relevance to users. Moreover, investors more likely to engage in frequent partial disposals of investments in associates, such as venture capital organisations, have an option to measure their investments in associates at fair value through profit or loss.

46. View A provides a faithful representation of an investment that is comprised of instruments with the same voting rights and the same rights to returns. These instruments are equivalent to each other, and the investor would consider them fungible.

47. View A also provides faithful representation of an investment when the investor manages the investment as a single asset and recovery it by sale of the investment as a whole, or by collecting dividends. An investor managing the investment as a single asset arguably would not engage in frequent partial disposals of the investment.

48. Changes in the carrying amount of the investment applying View A (and the partial disposal gain or loss) are easy to understand because they are a proportion of the total carrying amount of the investment.

49. Finally, applying View B would involve additional costs to allocate fair value adjustments separately to each part and identify the portion sold in a partial disposal.

Staff recommendation

50. Taking the analysis into consideration the staff recommends the IASB to proceed with View A that an investor is measuring a single investment in the associate.

51. If the IASB agrees that View A is preferable, the staff also recommends the IASB revisit the tentative decision it made in June 2022 and require an investor applying the preferred approach to measure the portion to be derecognised in a partial disposal as a proportion of the carrying amount of the investment at the date of the disposal.

Question to the IASB
Does the IASB agree with the staff recommendation?