IASB meeting

Date	**December 2022**
Project	**Equity Method research project**
Topic	**Application question—Purchase of additional interest in an associate and share of unrecognised losses**
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Purpose of the paper

1. The purpose of this paper is to ask the International Accounting Standards Board (IASB) to address the application question: *Does an investor that has reduced its interest in an associate to nil 'catch up' unrecognised losses if it purchases an additional interest in the associate.*

Structure of the paper

2. The paper is structured as follows:

   (a) description of the application question;

   (b) staff analysis and recommendation; and

   (c) question to the IASB.

Description of the application question

3. Paragraph 38 of IAS 28 *Investments in Associates and Joint Ventures* requires that, if an investor's share of losses equals or exceeds its interest in the associate, the investor does not recognise its share of further losses.

4. Paragraph 39 of IAS 28 requires that, after the carrying amount of investor's interest is zero, additional losses are provided, and a liability is recognised, only to the extent that the investor has incurred a legal or constructive obligation or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of profits equals the share of losses not recognised.

5. The fact pattern in the application question is:

   (a) an investor’s share of an associate’s losses exceeds the carrying amount of the investment in the associate, including long-term interests that in substance form part of the net investment in the associate;

   (b) the investor has reduced the carrying amount of its investment to zero and has not recognised a liability of its share of losses that exceeds its investment; and

   (c) subsequently, the investor purchases an additional interest in the associate.

6. IAS 28 does not specify if at the date of purchasing the additional interest, the investor should recognise its share of the unrecognised losses by deducting the unrecognised losses from the cost of the additional investment.

7. For example:

   (a) an investor has reduced its investment in an associate to zero and its share of unrecognised losses is 50CU. In the following period, the investor purchases an additional interest of 10% in the associate and pays 200CU. At the date of purchasing the additional interest the fair value of the associate’s net assets is 100CU.

   (b) applying the preferred approach (see Agenda Paper 13A, IASB meeting December 2022), the investor recognises the additional interest’s share in the fair value of the associate’s net assets of 10CU and goodwill as the difference between the fair value of the consideration paid and the additional interest’s share in the fair value of the associate’s net assets.

8. In this example, does the investor recognise the unrecognised losses of 50CU from the carrying amount of the investment? Recognising the losses would reduce the carrying amount of the investment to 150CU at the purchase date.

Staff analysis and recommendation

Purchases of an additional interest in an associate

9. The IASB is discussing the application question: *How does an investor apply the equity method when purchasing an additional interest in an associate while retaining significant influence*[1].

10. In discussing this application question the IASB has been exploring its preferred approach (see Agenda Paper 13A of this meeting). The preferred approach would not remeasure the previously held interest to fair value at the date of purchase of the additional interest in an associate. If the investor were to remeasure its previously held interest to fair value at the date of purchasing the additional interest in an associate, then arguably the previous unrecognised losses would be included in the remeasurement of the investment and the application question in paragraph 1 of this paper would not arise.

Principles underlying IAS 28

11. At the June 2021 meeting, the IASB discussed the principles that have been identified as underlying the requirements in IAS 28[2]. The principles aim to provide the Board with a toolkit that can help in analysing the application questions and develop solutions.

12. In relation to the application question in paragraph 1 of this paper, the staff considered:

    Principle F—an investor's maximum exposure is the gross interest in the associate.

13. Principle F establishes the limit to the recognition of losses that the investor recognises for the investment held. However, it is not sufficient to provide a solution to the application question in paragraph 1 of this paper.

14. As the principles do not provide an answer to the application question, the staff assessed the requirements in other IFRS Accounting Standards that address similar or related issues.

15. Paragraph 26 of IAS 28 states that many of the procedures that are appropriate for the application of the equity method are similar to consolidation procedures described in IFRS 10 *Consolidated Financial Statements*. The requirements in IFRS 10 that apply to recognition of losses and purchase of additional interests are:

    (a) paragraph B94 of IFRS 10 requires a parent continues attributing losses to the non-controlling interest even if this results in the non-controlling interest having a deficit balance. The requirement applies even if the non-controlling interest has no obligation to cover the losses;

[1] See Agenda Paper 13A *Purchase of an additional ownership interest in an associate without a change in significant influence* of the April 2022 IASB meeting and IASB Update April 2022

[2] See Agenda Paper 13 *Identifying the principles in IAS 28* Investments in Associates and Joint Ventures of the June 2021 IASB meeting and IASB Update June 2021

(b) paragraph B96 of IFRS 10 requires that, when the proportion of the equity held by the non-controlling interest changes, a parent adjusts the carrying amount of non-controlling interest and recognises in equity the difference between the adjustment and the fair value of the consideration paid.

16. The staff noted that the requirements in IFRS 10 derive from the entity concept in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework)* that non-controlling interests in a subsidiary are part of the equity of the group. However, an additional interest in an associate is not part of the group's equity.

17. Therefore, the staff does not think a link can be made between acquiring part of a non-controlling interests and the recognition of unrecognised losses on the purchase of an additional interest in an associate.

Accounting guidance in US GAAP

18. US GAAP includes requirements for when an investor purchases an additional interest after discontinuing the recognition of losses. ASC323-10-35-29 requires an investor to recognise previously unrecognised losses up to the amount of the additional interest determined to represent funding of prior losses. Judgement is required for this assessment and the Codification provides factors to make the assessment.

19. The Codification states that if the additional interest is purchased from a third party and the investee does not obtain additional funds, it is unlikely that, in the absence of the other factors, prior losses are being funded.

Other reference sources

20. Material from accounting firms does not answer this application question, except for one firm recommending an approach similar to the US GAAP requirements.

Applying the equity method

21. If the investor were to recognise its share of unrecognised losses, the losses would be recognised in profit or loss at the date of purchasing the additional interest in the associate. Applying the equity method an investor recognises in profit and loss:

(a) its share of the associate's profit or loss; and

(b) any impairment losses.

22. IAS 28 states that recognising the items in paragraph 21(a) is a better measure of income than distributions received from the associate, as distributions received may not be an adequate measure of the income earned by an investor on an investment in an associate. The equity method is not attempting to measure the value of the investment. Consequently, the investors share of the associate's losses is recognised as a function of applying the equity method and not from assessing whether the investment in the associate is impaired.

23. The staff thinks that to answer the application question in paragraph 1 of this paper it is helpful to consider whether the recognition of the unrecognised losses is a function of applying the equity method, as for item in paragraph 21(a); or whether it should depend on an assessment of whether the additional interest in the associate is impaired.

Arguments against immediate recognition of unrecognised losses

Is the additional interest an asset?

24. Paragraph 4.3 of the *Conceptual Framework* defines an asset as a present economic resource controlled by the entity as a result of past events. The additional interest:

    (a) provides the investor with a right to an additional share of the associate's net assets as well as share of distributions;

    (b) has potential to produce economic benefits in the form of future distributions from the associate; and

    (c) is under the control of the investor (in so much the investor can dispose of the interest), that has legal ownership of it.

25. In the staff's view, provided the factors in paragraph 24 exist, the additional investment meets the definition of an asset in the *Conceptual Framework*.

Faithful representation of the transaction

26. Purchases of an additional interest in an associate could be to fund research or development. An existing investor may invest further in the associate on the expectation that the associate's financial performance will improve, and the investor will recover its investment and earn a positive return.

27. The immediate recognition of unrecognised losses may not provide a faithful representation in these circumstances, because the purchase of an additional interest in an associate does not decrease the investor's economic resources. This view is aligned with the view that recognition of the unrecognised losses should depend on the assessment of whether the additional interest in the associate is impaired (see paragraph 23 of this paper).

Relevant information on the transaction

28. The staff understands that users of financial statements are interested in the return on an investment in an associate and/or assessing its fair value. The return on the investment is determined by the ratio between the share of profit or loss and the cost of the investment. The immediate recognition of unrecognised losses reducing (or eliminating) the cost of the additional investment would decrease the denominator of the ratio. The ratio in future periods would be artificially high and may not be used to assess the prospective for future cash flows or management's stewardship of the economic resources.

29. Therefore, the immediate recognition of unrecognised losses of the purchase of an additional interest may not provide relevant information to users of financial statements.

Reasons supporting recognition of unrecognised losses

Comparability

30. The staff is of the view that not recognising unrecognised losses on the purchase of an additional interest may affect comparability. For example:

    (a) Entity X purchases 30% of Associate A for 300CU at 1/1/20X1 and obtains significant influence;

    (b) Entity Y purchases 20% of Associate A for 200CU at 1/1/20X1 and obtains significant influence;

    (c) Associate A reports losses for 1,500CU during 20X1; and

    (d) Entity Y purchases an additional 10% interest for 100CU at 31/12/20X1.

31. Entity X's share of losses is 450CU. Applying IAS 28, Entity X would recognise 300CU, reducing its investment to zero, and leave 150CU of losses unrecognised.

32. Entity Y's share of losses is 300CU. Applying IAS 28, Entity Y would recognise 200CU, reducing its investment to zero, with its share of unrecognised losses being 100CU. Entity Y would then measure its additional investment at 100CU.

33. Both investors at the end of 31/12/X1 hold a 30% share and have paid 300CU, however the carrying amount of their investment in Associate A is different. Some would argue that a different pattern of acquiring the interest should not affect the outcome. Whereas others would argue the investors made different economic decisions and that the equity method does not aim to provide a current value of the investment.

Application of the equity method of accounting

34. Applying the equity method in IAS 28 requires recognition of losses irrespective of whether the investment is impaired, including the allocation of losses to any long-term interests that form part of the investor's net investment in the associate. The recognition of unrecognised losses when purchasing an additional interest in an associate could (arguably) be seen as extending the application of equity method in IAS 28 to the additional investment. This argument is aligned with the view that recognition of the unrecognised losses is a function of applying the equity method (see paragraph 23 of this paper).

Staff recommendation

35. After considering the arguments above, the staff recommends that an investor that has reduced its interest in an associate to zero does not recognise the unrecognised losses from the cost of the additional interest in the associate.

36. Applying the recommendation does not mean that the unrecognised losses are ignored because an investor, applying paragraph 39 of IAS 28, will not recognise its share of profit (including the share of profit attributable to the additional interest) until the share of profit equals the previous share of unrecognised losses.

37. The staff however notes that the fact pattern in paragraph 5 of this paper occurs when the associate's losses have exceeded its net assets. A negative net asset position may be an indicator of financial difficulty, which paragraph 41A of IAS 28 lists as objective evidence of impairment. The investor may need to assess if the additional interest in the associate is impaired.

38. The staff has considered the interaction between the recommendation in paragraph 35 and the analysis in Agenda Paper 13A on applying the IASB's preferred approach. The staff thinks that the application question in this paper is a matter of initial recognition and initial measurement, while the analysis in Agenda Paper 13A focuses on how the investor applies the preferred approach after the date of purchase of an additional interest. As noted in that paper, the initial measurement of the investment is the same under both views.

Question to the IASB
Does the IASB agree with the staff recommendation in paragraph 35 of this paper?