IFRS

STAFF PAPER

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IASB® meeting

Project	**Equity Method**
Paper topic	Purchase of an additional interest (and disposal of an 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) discussed the application question: *How does an investor apply the equity method when purchasing an additional interest in an associate while retaining significant influence*.

2. The IASB discussed possible approaches to the application question and asked the staff to develop its analysis further applying its 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, its additional share in the fair value of the associate's net assets and measures that additional interest at the fair value of the consideration transferred.

3. The IASB also asked the staff to consider the implications for an 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 net assets at fair value and remeasures the cost of the investment at fair value at the date of acquiring an additional interest in an associate while retaining significant influence.

4. This paper extends the analysis of the application question in paragraph 1 of this paper to two further transactions, in which an investor retains significant influence and:

   (a) purchases an additional interest that is a bargain (paragraphs 11 to 19 of this paper).

   (b) makes a partial disposal (paragraphs 20 to 37 of this paper).[1]

Staff recommendation

5. The staff recommend that in applying the preferred approach while retaining significant influence:

   (a) an investor purchasing an additional interest that is a bargain recognises the bargain purchase gain separately in profit or loss.

   (b) an investor making a partial disposal determines the portion of the carrying amount of an investment in the associate to be derecognised by applying:

      (i) a specific identification method, if the investor can identify the specific portion of the investment being disposed of and its cost; or

      (ii) the last-in first-out (LIFO) method.

Structure of the paper

6. The paper is structured as follows:

   (a) Scope of the analysis (paragraphs 7–9 of this paper);

   (b) Applying the preferred approach to the further transactions (paragraphs 10–37 of this paper);

   (c) Applying the alternative approach to the further transactions (paragraphs 38–49 of this paper);

[1] In this paper, a transaction in which an investor sells part of its interest in an associate while retaining significant influence is referred to as a partial disposal.

(d) Questions to the IASB; and

(e) Appendix A (illustrative example).

Scope of the analysis

7. The analysis in this paper has been developed for investments in associates. IFRS Accounting Standards require the equity method of accounting for joint ventures and permit the equity method for investments in subsidiaries in the separate financial statements of a parent entity.

8. At a later stage of the project, the staff will apply the IASB's tentative decisions to investments other than associates and discuss any implications with the IASB.

9. The assumptions applied in the analysis on purchase of an additional interest that is a bargain include:

    (a) the purchase transactions are not linked. Linked transactions often occur when, for instance, the transactions are entered into near or at the same time, and/or the counterparty is the same.

    (b) all purchase transactions are at arm's length.

Applying the preferred approach to the further transactions

10. At its April 2022 meeting, most IASB members expressed support for the preferred approach (see paragraph 2 of this paper). The preferred approach would require an investor to recognise:

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

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

    (c) any positive difference between (a) and (b) as goodwill.

Purchase of an additional interest that is a bargain

11. In a bargain purchase, at the date of the purchasing the additional interest, the fair value of the consideration transferred is less than the investor's additional share in the fair value of the associate's net assets. Appendix A provides an illustrative example of applying the preferred approach to a purchase of an additional interest that is a bargain.

12. At its April 2022 meeting, the IASB discussed that the preferred approach would require an investor, having obtained significant influence, to measure its additional interests in an associate as an accumulation of purchases. The investment would effectively be in layers:

    (a) initial layer, the ownership interest at the date the investor obtains significant influence. The investor recognises and measures the initial layer at the date when significant influence is obtained, as the sum of:

        (i) the investor's share in the fair value of the associate's net assets at the date significant influence is obtained; and

        (ii) goodwill, carried as part of the investment.

    (b) additional layers, for each purchase of additional interest. The investor recognises and measures each additional layer at the date of each purchase, as the sum of:

        (i) the additional layer's share in the fair value of the associate's net assets at the purchase date; and

        (ii) goodwill, carried as part of the investment, measured at each purchase date.

13. In the illustrative example, as set out in Appendix A to this paper, the initial layer of the investment includes implicit goodwill (220 CU) as part of the investment. The example illustrates an additional purchase in which a gain of 60CU arises. The staff considered two alternative views:

    (a) view A—the investor should recognise the bargain purchase gain separately in profit or loss; and

(b) view B—the investor should recognise the bargain purchase gain as part of any goodwill recognised previously in the carrying amount of the investment. That is the bargain purchase gain is offset from previously recognised goodwill.

14. The staff note that the issue in paragraph 13 does not arise in a business combination because the goodwill or bargain purchase gain is determined at the date control is obtained. IFRS 3 *Business Combinations* revised in 2008 eliminated cost accumulation practices in business combinations achieved in stages.

15. Applying the preferred approach an investor measures its investment in the associate as an accumulation of purchases after obtaining significant influence. The measurement of each layer is separate; therefore, the investor does not remeasure previously held interests in the associate or its share in the fair value of the associate's net assets.

16. The preferred approach would measure goodwill on the initial and each additional layer separately. The staff think that logically the initial layer could recognise goodwill (as part of the carrying amount of the investment) and subsequent layers could recognise the bargain purchase gain in profit or loss, albeit relating to the same investment in the associate.

17. Consequently, the staff could not find a reason to support offsetting the bargain purchase gain from any goodwill previously recognised in the carrying amount of the associate, as per view B of paragraph 13 of this paper.

18. In relation to the interaction between a bargain purchase gain and the impairment requirements for an investment in an associate, the staff noted that a bargain purchase gain on an additional interest is not included in the list of loss events in paragraph 41A of IAS 28 *Investments in Associates and Joint Ventures*.[2] The staff think that if the preferred approach is applied and a bargain is recognised separately paragraph 41A of IAS 28 could be amended. The amendment would add to the list of loss events if the price paid (per share) for an additional interest is lower than the carrying amount (per share) of the previously held interest, the investor should consider whether the bargain purchase indicates that an impairment has occurred. Paragraph 42 of IAS 28 requires an

[2] Paragraphs 41A to 41C of IAS 28 list events that provide evidence that the investment may be impaired.

investor to test for impairment the entire carrying amount of the investment in accordance with IAS 36 *Impairment of Assets.*

19. Therefore, the staff think that the preferred approach would require an investor purchasing an additional interest that is a bargain to recognise that gain separately in profit or loss.

Partial disposal

20. In a partial disposal, an investor sells part of its investment in an associate and retains significant influence. There is no change in the classification of the investment.

21. The staff think that applying the preferred approach to 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).

22. As noted, applying the preferred approach an investor measures its investment in the associate as an accumulation of purchases after obtaining significant influence. The share of the associate's net assets and the goodwill included in each layer are measured by reference to the fair value at the date of each purchase that occurred after the investor obtained significant influence.

23. When the investment includes layers, the measurement of the portion to be derecognised requires the investor to identify which layer has been disposed of. If instead, an investor has acquired its interest in a single transaction, the investment includes only the initial layer, and no identification is required.

24. IAS 28 does not include requirements on how to determine the portion of the carrying amount of the investment to be derecognised in a partial disposal. Requirements in other IFRS Accounting Standards for similar transactions include:

(a) Paragraph 25 of IAS 2 *Inventories* requires to assign cost to inventories, unless they are not ordinarily interchangeable, by using the first-in first-out (FIFO) or weighted average cost formula:

(i) The FIFO formula assumes that the items of inventory that were purchased first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased.

(ii) Applying the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased during the period.

(b) Paragraph 3.2.13 of IFRS 9 *Financial Instruments* requires that, if the transferred asset is part of a larger financial asset and the part transferred qualifies for derecognition, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part to be derecognised on the basis of the relative fair values of those parts at the date of the transfer.

Specific identification

25. In measuring and assigning cost, faithful representation is achieved by using specific identification of the cost attributable to an asset. IFRS Accounting Standards requiring a specific identification method include the requirements in paragraph 23 of IAS 2 and paragraph 17 of IAS 16 *Property Plant and Equipment.* However, these methods require an entity to be able to objectively identify a specific item.

26. In the case of a partial disposal of an interest in an associate, specific identification would require an entity to objectively identify which portion (ie the shares) of the investment is being disposed of. Specific identification may be possible for instance, when the investor purchased an additional interest and wrote a call option on that

additional interest. However, shares belonging to the same class have the same rights and are therefore interchangeable and generally, the staff does not consider that it will be possible to use a specific identification method.

Weighted average method

27. Using a weighted average method to identify the portion of the investment to be derecognised would, in the staff's view, be inconsistent with the layered interests of the preferred approach. This is because this method reflects a view that the investment is measured as a single asset. In other words, each share (interest) is part of a pool of identical assets and is therefore interchangeable.

28. Therefore, the staff concluded that the weighted average method does not provide the most faithful representation of the transaction.

FIFO method

29. Applying a FIFO method would require the investor to identify the layer that is being disposed of and is consistent with the preferred approach which recognises layers of an investment. However, applying the FIFO method an investor would derecognise the portion of the investment that was first acquired, that is the initial layer of the investment.

30. Applying the preferred approach, the initial layer is the layer measured on obtaining significant influence. Therefore, derecognising a portion of the initial layer (assuming the value of the investment is increasing) would result in the largest gain compared to a weighted average or last-in-first-out methods. However, as the investor retains significant influence, it would seem inappropriate to derecognise a portion of the initial layer.

31. The staff concluded that FIFO does not provide the most faithful representation of the transaction as the portion to be derecognised relates to the initial layer.

LIFO method

32. The LIFO method treats the newest items as being sold first, and consequently the retained items are recognised as if they were those bought at the earliest date.

33. Applying the LIFO method an investor would identify the layer that was most recently purchased as the portion to be derecognised. Therefore, the LIFO method results in retaining the initial layer ownership measured on obtaining significant influence.

34. The IASB eliminated LIFO from IAS 2. The staff considered if the arguments for elimination in IAS 2 apply to identify the portion of the carrying amount of an investment in an associate to be derecognised. The IASB explained that LIFO was not a faithful representation of the physical flow of inventory and that the use of LIFO results in inventories being recognised at amounts that bear little relationship to recent cost levels of inventories[3].

35. These arguments do not apply because for an investment in an associate, the disposals do not correspond to a physical flow, and the retained part is not measured at its original cost because it has been adjusted for the post-acquisition changes in the associate's net assets.

36. The staff concluded that LIFO would be an acceptable method for recognising the portion of the investment to be derecognised in a partial disposal and would provide the most faithful representation of the transaction.

37. Therefore, the staff think that applying the preferred approach, in a partial disposal, an investor determines the portion of the carrying amount of the associate to be derecognised by applying:

    (a) a specific identification method, if the investor is able to identify the specific portion of the investment being disposed of and its cost; or

    (b) the LIFO method.

Applying the alternative approach to the further transactions

38. Compared to the preferred approach, the alternative approach discussed in Agenda Paper 13A for the April 2022 IASB meeting (see paragraph 3 of this paper) would measure the

[3] See paragraphs BC10 and BC13 of the Basis for Conclusion of IAS 2.

investment in an associate as a whole and provide fair value information on the investment updated to the date of the latest purchase of an additional interest.

39. Applying the alternative approach, an investor that purchases an additional interest having obtained significant influence:

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

(b) recognises the cost of the additional interest at the fair value of the consideration transferred;

(c) remeasures the previously held interest at fair value at the date of the purchase of the additional interest; and

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

Purchase of an additional interest that is a bargain

40. Applying the alternative approach, the purchase of an additional interest that is a bargain would arise only in relation to the investment as a whole, as the investment is measured as a single asset. The discussion in paragraph 13 of this paper would not apply.

41. The staff think that there is a possible complexity in applying the alternative approach to a bargain purchase. The alternative approach requires the investor to remeasure previously held interests to fair value at the date of the purchase of the additional interest. IFRS 13 *Fair Value Measurement* defines fair value as:

> the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

42. Paragraph 371 of the Basis for Conclusion of IFRS 3 explains that circumstances in which bargain purchases occur include a forced liquidation or distress sale (barring errors in measuring fair values of the net assets acquired). A forced liquidation or distress sale is not an orderly transaction.

43. Therefore, an investor applying the alternative approach to a bargain purchase may encounter complexity in determining the fair value of previously interests.

Partial disposal

44. The staff think that an investor applying the alternative approach to a partial disposal would report both:

    (a) a gain or loss on the disposal of the transferred part of the investment; and

    (b) a gain or loss on the remeasurement of the retained part of the investment to its fair value at the date of the disposal.

Disposal gain or loss

45. Reporting the gain or loss on disposal of the transferred part of the investment would involve the same steps as in applying the preferred approach (see paragraph 21 of this paper):

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

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

    (c) recognise the difference between (a) and (b) as a disposal gain or loss when the transferred part of the investment is derecognised.

46. It would not be necessary to specify a method to determine the carrying amount of the portion to be derecognised. Applying the alternative approach, the measurement of the whole interest and the share of the associate's net assets is based on the fair value at the same date (the date of the last purchase). The carrying amount of the portion to be derecognised would then be proportional to the share of ownership disposed of; for example, if an investor held 25% and disposes of 5%, the investor would derecognise 5% of the carrying amount of the investment.

Remeasurement of retained interest

47. An investor applying the alternative approach to the purchase of an additional interest remeasures the previously held interest because the alternative approach assumes that fair value provides the most relevant information for an investment in an associate at the date of the purchase. The same argument would apply to the retained interest in a partial disposal.

48. Paragraph 24 of IAS 28 requires that an investor does not remeasure its interest when it loses joint control while acquiring significant influence or loses significant influence while acquiring joint control. The IASB acknowledged that the investor-investee relationship changes and, consequently, so does the nature of the investment. However, considering that there is neither a change in the group boundaries nor a change in the measurement requirements, the IASB concluded that losing joint control and retaining significant influence is not an event that warrants remeasurement of the retained interest.[4]

49. The staff observe that the IASB would have to further consider, if the alternative approach was retained, the interaction with the requirement in paragraph 24 of IAS 28.

Questions to the IASB
1. Does the IASB agree with the staff recommendation in paragraph 5 of this paper that in applying the preferred approach while retaining significant influence: (a) an investor purchasing an additional interest that is a bargain recognises the bargain purchase gain separately in profit or loss? (b) an investor making a partial disposal determines the portion of the carrying amount of an investment in the associate to be derecognised by applying: (i) a specific identification method, if the investor can identify the specific portion of the investment being disposed of and its cost; or (ii) the LIFO method? 2. Do you have comments or questions on the analysis in the paper?

[4] See paragraph BC30 of the Basis for Conclusions of IAS 28.

Appendix A—Illustrative example

A1. The example in this Appendix illustrates the application of the preferred approach to a purchase of an additional interest that is a bargain.

A2. Investor acquires a 20% share in investee at 1/1/20X1 for a consideration of 1,100CU. and obtains significant influence. At that date, the fair value of the associate's net assets is 4,400CU. The profit or loss of the investee for the year ending on 31/12/20X1 is 700CU, including the effects of the adjustments based on the fair values of the investee's net assets at the date significant influence is obtained.

The accounting entries for the year ending 31/12/20X1 are as follows:

To recognise the interest in the associate		
Dr Investment in associate	CU1,100	
Cr Cash		CU1,100
To recognise the investor's share of the associate's profit or loss		
Dr Investment in associate	CU140	
Cr Profit or loss		CU140

A3. At 31/12/20X1 the reconciliation of the carrying amount of the associate is:

	Acquisition	**Post-acquisition changes**	**Total**
Share of net assets	880	140	1,020
Goodwill	220	-	220
Total	1,100	140	1,240

A4. At 1/1/20X2 the investor acquires an additional 10% share for a consideration of 640CU. At that date, the fair value of the associate's net assets is 7,000CU.

A5. An investor applying the preferred approach (particularly, paragraph 13(a) of this paper) accounts for the purchase of the additional interest as follows:

Dr Investment in associate	CU700	
Cr Cash		CU640
Cr Profit or loss		CU60

A6. At 1/1/20X2 the reconciliation of the carrying amount of the associate is:

	Previous interest	Additional interest	Total
Share of net assets	1,020	700	1,720
Goodwill	220	-	220
Total	1,240	700	1,940

A7. Were the investor to offset the bargain purchase gain against the goodwill included in the previously held interest (ie applying paragraph 13(b) of this paper), the accounting entry for the purchase and the reconciliation of the carrying amount of the associate would respectively be:

Dr Investment in associate	CU700	
Cr Cash		CU640
Cr Investment in associate		CU60

	Previous interest	Additional interest	Total
Share of net assets	1,020	700	1,720
Goodwill	220	-	220
Bargain purchase gain	(60)	-	(60)
Total	1,180	700	1,880