IASB PUBLISHES EXPOSURE DRAFT EQUITY METHOD OF ACCOUNTING IAS 28 INVESTMENTS IN ASSOCIATES AND JOINT VENTURES

STATUS

Exposure draft - Comments on the Exposure Draft were closed on 20 January 2025.

ACCOUNTING IMPACT

The Exposure Draft proposes a revision to IAS 28, which might significantly affect entities that apply the equity method. Entities with loss-making associates or joint ventures and entities with transactions with associates or joint ventures might be particularly affected due to the clarifications and measurement changes proposed by the Exposure Draft.

ENTITIES AFFECTED BY THE PROPOSED REQUIREMENTS

The proposals are expected to significantly affect entities that apply the equity method. Entities that have upstream or downstream transactions with associates or joint ventures would be particularly affected due to the proposed requirement to recognise full gains and losses from all upstream and downstream transactions. Currently there is lack of clarity on certain aspects related to recognition of investor's or joint venturer's share of losses, which the Exposure Draft proposes to address. As a result, entities with loss making associates or joint ventures might need to change the recognition of their share of losses depending on the accounting policy followed by them currently.

PROPOSALS RELATED TO INITIAL MEASUREMENT ON OBTAINING SIGNIFICANT INFLUENCE

IAS 28.10 requires an investment in an associate or a joint venture to be recognised at cost on initial recognition. However, IAS 28 does not currently specify how to measure the cost of the investment when obtaining significant influence. As a result, the following application questions arose, leading to diversity in practice:

► how an investor initially measures the carrying amount of an investment in an associate;
► if an investor with a previously held interest in an entity acquires an additional interest and obtains

significant influence, whether the initial measurement of the investment in an associate includes the original purchase cost of the previously held interest or the carrying amount of that interest applying IFRS 9 Financial Instruments; and

► whether an investor or joint venturer includes in the consideration transferred any contingent consideration, and if so, how the contingent consideration is measured.

Definition of the cost of the associate or joint venture

The Exposure Draft proposes to define the cost of the associate or joint venture as below:
"Fair value of the consideration transferred, including the fair value of any previously held ownership interest (or any investment retained) in the associate or joint venture, measured at the date an investor obtains significant influence or a joint venturer obtains joint control."

Contingent consideration

The Exposure Draft also proposes the following with respect to contingent consideration:

► Recognition of contingent consideration as part of the consideration transferred, to be measured at fair value.
► Classification of contingent consideration as a financial liability or equity in accordance with the requirements of IAS 32 Financial Instruments: Presentation.
► Classification of a right to the return of previously transferred consideration as an asset.
► Subsequent measurement of contingent consideration classified as a liability at fair value at each reporting date, with changes in fair value recognised in profit or loss.

Deferred tax effects

The proposals also require inclusion in the carrying amount of the associate or joint venture the deferred tax effects related to the investor's share of the fair value of the associate's or joint venture's identifiable assets and liabilities. These deferred tax effects arise due to the difference between the tax bases and the fair value of the net assets of the associate or joint venture on the date the ownership interest giving significant influence is acquired. The deferred tax effects would be subsequently reversed, as and when the related fair value adjustments reverse, as part of the adjustments made to the investor's share of the associate's profit or loss after the date of obtaining significant influence. For example, adjustments are made to the investor's or joint venturer's share of the associate's or joint venture's profit or loss to account for depreciation of the associate's depreciable assets based on their fair values at the date of obtaining significant influence.

Presentation of bargain purchase gain

IAS 28.32(b) currently provides a presentation requirement to include a bargain purchase gain in the determination of the investor's share of the associate's profit or loss in the period in which the investment is acquired. This requirement is removed in the Exposure Draft since IFRS 18 Presentation and Disclosure in Financial Statements now specifies the requirements related to presenting income and expenses in an investor's statement of profit or loss (Basis for Conclusions on the Exposure Draft - BC19).

PROPOSALS RELATED TO CHANGES IN OWNERSHIP INTEREST WHILE RETAINING SIGNIFICANT INFLUENCE

After initial recognition of an investment in an associate, the investor's ownership interest in the associate might change in the following ways, while the investor retains significant influence:

► Purchase of an additional ownership interest: For example, Entity A holds 25% interest in Entity B, which gives Entity A significant influence over Entity B. Entity A purchases an additional 10% interest, which results in Entity A continuing to have significant influence over Entity B, rather than obtaining control of Entity B.

► Disposal of an ownership interest: For example, Entity A holds 30% interest in Entity B, which gives Entity A significant influence over Entity B. Entity A sells 5% interest in Entity B, retaining 25% interest. Thus, Entity A continues to have significant influence over Entity B.

► Other reasons such as redemption or issue of equity investments by the associate or joint venture: For example, Entity A holds 30% interest in Entity B, which gives Entity A significant influence over Entity B. Entity B issues additional equity shares to Entity C, which results in dilution of the holding of Entity A to 25%. Entity A continues to have significant influence over Entity B after the dilution.

IAS 28 does not currently specify how to apply the equity method in the above circumstances, resulting in diversity in practice.

Purchase of an additional ownership interest

The proposals require an investor or joint venturer purchasing an additional ownership interest while retaining significant influence or joint control:

a. to recognise that additional ownership interest and measure it at the fair value of the consideration transferred;

b. to include in the carrying amount of that additional ownership interest the investor's share of the fair value of the associate's identifiable assets and liabilities; and

c. to account for any difference between (a) and (b) either as goodwill included as part of the carrying amount of the investment or as a gain from a bargain purchase in profit or loss.
It should be noted that in case of purchase of an additional ownership interest, while retaining significant influence or joint control; the previously held interest is not proposed to be remeasured at

fair value. However, when a purchase of an additional ownership interest results in the investor obtaining significant influence or joint control for the first time, the previously held interest is remeasured at fair value.

The proposed requirements related to contingent consideration and any related deferred tax would also apply to the purchase of an additional ownership interest.

Disposal of an ownership interest

The proposals require an investor or joint venturer disposing an ownership interest while retaining significant influence or joint control:

- ► to derecognise the disposed portion of its investment in the associate;
- ► to measure the disposed portion of its investment as a percentage of the carrying amount of the investment (that percentage is calculated as the disposed ownership interest divided by the total ownership interest); and
- ► to recognise any difference between the consideration received and the disposed portion as a gain or loss in profit or loss

In cases of disposal of ownership interest, while retaining significant influence or joint control, IAS 28.25 currently requires the investor or joint venturer to reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that decrease in ownership interest if that gain or loss would be required to be reclassified to profit or loss on disposal of the related assets or liabilities. There is no change proposed for this requirement.

Other changes in ownership interest

If an investor's or joint venturer's ownership interest changes as a result of other reasons, such as issue or redemption of shares by the associate or joint venture and the investor retains significant influence over the associate or joint venture, the proposals require the investor to account for the change in ownership interest as below:

- ► Increase in ownership interest
  An increase in ownership interest would be accounted for similar to purchase of an additional ownership interest while retaining significant influence. As there is no consideration transferred, the additional ownership interest would be recognised at the investor's or joint venturer's share of the change in its associate's or joint venture's net assets arising from the associate's or joint venture's redemption of equity instruments.
- ► Decrease in ownership interest
  A decrease in ownership interest would be accounted for similarly to the disposal of an ownership interest while retaining significant influence. As there is no consideration received, gain or loss would be recognised as the difference between 'the investor's or joint venturer's share of the change in its associate's or joint venture's net assets arising from the associate's or joint venture's issue of equity instruments' and the disposed portion.

PROPOSALS RELATED TO INVESTOR'S SHARE OF LOSSES

IAS 28.38 requires an investor or joint venturer to discontinue recognising its share of losses, if the carrying amount of its investment is reduced to nil. IAS 28.39 requires additional losses to be provided, and a liability recognised, only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture 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.

The application questions that arose with respect to recognition of losses when an investor's or joint venturer's interest in an associate or joint venture is reduced to nil included the following:

► 'Catch up' of unrecognised losses if the investor or joint venturer purchases an additional interest: When an investor or joint venturer purchases an additional ownership interest in the associate or joint venture, it is not clear whether the investor is required to recognise additional losses from the previously unrecognised losses when the original investment was reduced to nil.
► Separate recognition of each component of comprehensive income:

IFRS 18 (and IAS 1 Presentation of Financial Statements) requires an investor or joint venturer to present its share of the profit or loss from the associate or joint venture in the statement of profit or loss and its share of other comprehensive income (OCI) of the associate or joint venture in its OCI. There was a lack of clarify with respect to the following issues leading to diversity in practice:

- An associate or joint venture might report a loss in its statement of profit or loss and a loss in its OCI. If the investor's or joint venturer's share of those losses, in total, exceeds the carrying amount of its investment, IAS 28 does not specify the portion of the losses that should be recognised in profit or loss and in OCI by the investor or joint venturer.
- Once the investor or joint venturer has reduced the carrying amount of its investment to nil, the associate or joint venture might subsequently report a loss in its statement of profit or loss and income in its OCI (or vice versa). In such situations, it is not clear whether the investor or joint venturer should recognise any amounts for its share of the associate's or joint venture's loss (or profit) and OCI.

The proposals require the investor or joint venturer to recognise separately its share of the associate's or joint venture's profit or loss and its share of the associate's or joint venture's OCI. The proposals also require the following:

► No catch-up of unrecognised losses on purchase of an additional ownership interest:
On purchasing an additional ownership interest, the proposals require an investor or joint venturer that has not recognised its share of an associate's or joint venture's losses to not recognise those losses by reducing the carrying amount of the investment at the date of that purchase.
► Clarification of sequence of recognition of losses in profit or loss and OCI:
If an investor's or joint venturer's share of profit or loss and share of OCI are both losses that in aggregate equal or exceed its net investment in the associate or joint venture, the proposals require the investor or joint venturer to recognise first its share of profit or loss and then its share of OCI.
► Separate recognition of share of profit or loss and OCI with a nil net investment:

The proposals require an investor or joint venturer that has reduced its net investment to nil to continue to recognise separately its share of an associate's or joint venture's profit or loss and its share of an associate's or joint venture's other comprehensive income, retaining a carrying amount in the net investment of nil. The Exposure Draft proposes to retain the existing requirement in IAS 28 that an investor or joint venturer only recognises a liability for additional losses to the extent that it has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture.

PROPOSALS RELATED TO TRANSACTIONS WITH ASSOCIATES OR JOINT VENTURES

IAS 28.28 currently requires an investor or joint venturer to recognise gains or losses resulting from transactions, both upstream and downstream, with an associate or joint venture only to the extent of the unrelated investors' interests in the associate or joint venture. A number of application questions arose related to this issue, which included the following:

► Recognition of gains or losses from the sale of a subsidiary to an associate: There is an inconsistency between the requirements of IFRS 10 and IAS 28. IFRS 10.25 and IFRS 10.B97-B99 require an investor to recognise, in full, the gains or losses on the loss of control of a subsidiary, remeasuring any retained interest at fair value. IAS 28.28 requires an investor to restrict the gains or losses recognised to the extent of the unrelated investors' interests in an associate, by eliminating the investor's share of the gain or loss arising from the transaction. Therefore, if an investor sells a subsidiary to an associate, it is unclear as to how much gain or loss from the transaction should be recognised.

► Recognition of gains or losses from other transactions with an associate or a joint venture: There were several application questions related to the gains or losses from upstream and downstream transactions such as the following:

- Does an investor recognise the portion of its share of the gain in a downstream transaction that exceeds the carrying amount of its investment in the associate?
- Does an investor eliminate its share of a gain or loss in an upstream transaction from the carrying amount of the investment in the associate or the acquired asset?
- Does an investor eliminate its share of a gain or loss in a downstream transaction against the transaction gain or loss or the share of the associate's profit or loss?

The proposals require an investor or joint venturer to recognise in full the gains and losses resulting from all 'upstream' and 'downstream' transactions with its associates or joint ventures. This includes transactions of sale of subsidiary to an associate.

While developing these proposals, the factors considered by the IASB included the boundary of the reporting entity. In consolidated financial statements, subsidiaries are within the boundary of the reporting entity. Therefore, gains and losses from transactions with subsidiaries are eliminated. In both the Conceptual Framework and other IFRS Accounting Standards, an associate is not within the definition of a group. The Conceptual Framework explains that control over another entity determines the boundary of the reporting entity when preparing consolidated financial statements. The IASB observed that eliminating the investor's portion of the gain or loss in a transaction with an associate could be viewed as implying that, in applying the equity method, the boundary of the reporting entity is extended to include the associate (or the investor's share of the associate). This is one of the main reasons for the IASB to propose full recognition of gains and losses from 'upstream' and 'downstream' transactions with associates or joint ventures (Basis for Conclusions on the Exposure Draft – BC76-80).

PROPOSED TRANSITION REQUIREMENTS

The Exposure Draft requires the proposals to be applied prospectively, apart from certain exceptions, which include the following, that need retrospective application:

- ► Requirements related to gains or losses on transactions with associates or joint ventures: Any previously restricted portion of gains or losses from transactions with associates or joint ventures would be recognised in the opening balance of retained earnings.
- ► Investor or joint venturer early applying IFRS 10.B99A: An investor or joint venturer that early applied IFRS 10.B99A might have certain remaining portion from a previously restricted gain or loss from remeasurement at fair value of an investment retained in a former subsidiary. Such amount would be required to be recognised in the opening balance of retained earnings.
- ► Contingent consideration: Any contingent consideration for investments in associates or joint ventures purchased before the transition date would be recognised and measured at fair value at the transition date. The contingent consideration would be classified in accordance with proposed paragraph 26. Any corresponding adjustment in contingent consideration would be recognised in the carrying amount of the investments in associates or joint ventures at the transition date.
- ► Impairment implications of the above requirements: If, as a result of the retrospective application of the requirements specified above, the carrying amount of the investment in an associate or joint venture exceeds its recoverable amount at the transition date, the carrying amount would be reduced to the recoverable amount. The impairment loss would be recognised in the opening balance of retained earnings at the transition date.

If an investor or a joint venturer presents more than one period of comparative information, the Exposure Draft proposes to permit the investor or joint venturer to present comparative information for any additional prior periods unadjusted for the effects of the proposed requirements.

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