Staff paper

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IASB® meeting

Date	**June 2024**
Project	**Equity Method**
Topic	**Towards an Exposure Draft—Sweep issues**
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Purpose of this paper

1. At its March 2024 meeting, the International Accounting Standards Board (IASB) confirmed it was satisfied the applicable due process requirements had been complied with and that it had undertaken sufficient consultation and analysis to begin the process for balloting the Exposure Draft **Equity Method of Accounting** IAS 28 *Investments in Associates and Joint Ventures* (Revised) (Exposure Draft).

2. The staff have prepared the pre-ballot draft of the Exposure Draft and submitted it for review. We are now analysing the comments from the review and have identified sweep issues which we think IASB members should consider.

3. The purpose of this paper is to ask the IASB to decide how to address the sweep issues identified.

4. The recommendations in this paper would apply whenever the equity method of accounting is applied, that is including joint ventures and subsidiaries in separate financial statements.

Summary of staff recommendation

5. The staff recommend the IASB proposes:

   (a) to require that, when applying paragraph 39 of IAS 28, an investor:

      (a) does not separate components of comprehensive income; and

      (b) allocates its share of the associate's profit or loss and then its share of the associate's other comprehensive income to comprehensive losses not recognised;

   (b) to require that a parent entity that applies the equity method to its investment in a subsidiary in its separate financial statements and loses control of that subsidiary, but retains an interest in that former subsidiary that is an associate and continues to apply the equity method, applies paragraph 24 of IAS 28;

   (c) to delete the requirement in paragraph 32 of IAS 28 that specifies the line item in the statement of profit or loss in which an investor includes a bargain purchase gain in the period it acquires the investment (‘*included as income in the determination of the entity's share of the associate or joint venture's profit or loss*’);

   (d) not to specify the line item in the statement of profit or loss in which an investor includes income and expenses that arise when applying the equity method;

   (e) to require that an investor provides the same disclosures on contingent consideration for the purchase of an additional interest in an associate, as the investor does for the purchase of an associate; and

   (f) to require that, if an investor has recognised contingent consideration as an equity instrument and the investor measured that equity instrument at fair value at the date it obtained significant influence (or, for contingent consideration for the purchase of an additional interest, carried at the fair value at the date of the purchase), the investor does not remeasure that contingent consideration.

Structure of this paper

6. This paper is structured as follows:

   (a) recognition of comprehensive income when resuming recognition of profits (paragraphs 7–27 of this paper);

   (b) separate financial statements–losing control of a subsidiary accounted for using the equity method and retaining an interest in associate (paragraphs 28–36 of this paper);

   (c) profit or loss presentation–gain or loss from a disposal and changes in the fair value of contingent consideration classified as a financial liability (paragraphs 37–46 of this paper);

   (d) disclosure–contingent consideration on purchase of an additional interest (paragraphs 47–51 of this paper); and

   (e) transition–contingent consideration classified as equity instruments (paragraphs 52–58 of this paper).

Staff analysis

Recognition of comprehensive income when resuming recognition of profits

Background

7. Paragraph 38 of IAS 28 states:

> If an entity's share of losses of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further losses.

8. This requirement has not been reconsidered during the equity method project.

9. At its December 2022 meeting, the IASB considered the order of recognition for comprehensive income (profit or loss and other comprehensive income) when an investor applies paragraph 38 of IAS 28. The IASB considered the application question: *does an investor that has reduced the carrying amount of the investment to nil recognise each component of other comprehensive income separately*?[1]

10. The IASB tentatively decided:

    (a) to clarify that an investor would recognise its share of an associate's comprehensive income until its interest in the associate is reduced to nil.

    (b) that when an investor has reduced the carrying amount of its investment in an associate to nil the investor would recognise separately its share of each component of the associate's comprehensive income.

    (c) that if an investor's share of an associate's comprehensive income is a loss that is larger than that carrying amount of its investment in the associate, an investor would recognise in order its share of the associate's profit or loss, and its share of the associate's other comprehensive income.

Sweep issue

11. A question has been raised on whether the IASB should clarify the order when an investor that has reduced the carrying amount of its investment to nil resumes recognising its share of the associate's profits, following its share of profits exceeding its share of losses not recognised. In other words, will the order set out in paragraph 10(c) of this paper be applicable when an investor resumes recognition of the associate's comprehensive income?

[1] See Agenda Paper 13C -Recognition of losses and components of comprehensive income of the December 2022 IASB meeting.

Staff analysis

12. Paragraph 39 of IAS 28 states:

> … an investor resumes recognising its share of the associate's profits only after its share of the profits equals the share of losses not recognised.

13. Like paragraph 38 of IAS 28, paragraph 39 does not specify the order of recognition for comprehensive income when the investor's share of profits equals the share of losses not recognised.

14. In the staff's view, there are two possible answers to this additional application question:

    (a) the first is to account separately for each component of comprehensive income; or

    (b) the second is not to account separately for each component of comprehensive income, but to specify the order in which an investor recognises its share of the associate's comprehensive income to absorb its share of comprehensive losses not recognised.

15. The first answer would require an investor to resume recognising its share of each component of comprehensive income only when its share of profits from that component exceeds the losses not recognised for that component, for example an investor resumes recognising its share of the associate's profit only when its share of profit exceeds its share of losses not recognised from profit or loss.

16. The staff do not support this answer because:

    (a) there is no evidence that paragraphs 38–39 of IAS 28 should be applied separately to each component of comprehensive income;

(b) applying paragraphs 38–39 of IAS 28 separately for each component of comprehensive income would create complexity, for example an investor would need to track each component of comprehensive income;

(c) it could give rise to further application questions. For example, the investor's share of the associate's comprehensive income might exceed comprehensive losses not recognised, but its share of the profits from a component of comprehensive income does not exceed the losses not recognised from that component; and

(d) the IASB has tentatively decided that an investment in an associate should be viewed as a single unit of account.

17. In view of the analysis in paragraph 16 of this paper, the staff do not recommend the first answer to the application question.

18. Therefore, we recommend that the IASB sets out proposals in the Exposure Draft on the order in which an investor recognises its share of the associate's profits, following its share of profits exceeding its share of losses not recognised.

19. At its December 2022 meeting, the IASB considered as the basis for its tentative decision in paragraph 10(c) of this paper, paragraph 7.16 of the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) that states:

> The statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period.

20. Paragraph 7.16 notes many users of financial statements incorporate the total for profit or loss in their analysis either as a starting point for that analysis or as the main indicator of the entity's financial performance. For this reason, paragraph 7.17 of the *Conceptual Framework* states:

> Because the statement of profit of loss is the primary source of information about an entity's performance for the period, all income and expenses are, in principle, in that statement.

> However, in developing standards the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the statement of profit or loss providing more relevant information or providing a more faithful representation of the entity's financial performance for that period.

21. The staff considered what the implication is of profit or loss being the primary source of information in a situation where:

    (a) the investor has reduced its investment to nil and discontinued recognising its share of losses;

    (b) the associate subsequently reports profits, and the investor's share of comprehensive income exceeds the losses not recognised; and

    (c) the investor's share of profit or loss and the investor's share of other comprehensive income are profits.

22. Some argue the investment in the associate only generates positive performance to be recognised in profit or loss when comprehensive income equals the share of losses not recognised, whatever their origin is. Therefore, in each reporting period an investor applying paragraph 39 of IAS 28 would first allocate profits in the period to losses not recognised and secondly allocate other comprehensive income to any remaining losses not recognised.

23. For example, assume Investor E has a carrying amount of nil for its investment in associate A and comprehensive losses not recognised of CU200. In the current period, Investor E's share of the associate's profit or loss is a profit of CU150; and its share of other comprehensive income is CU90. Therefore, Investor E's share of comprehensive income is CU150+CU90=CU240.

24. Investor E would increase the carrying amount of its investment in associate A to CU40 (net total of losses not recognised of CU200 and share of comprehensive income of CU240). In the staff's view, Investor E should:

    (a) allocate all of its share of profit and loss (CU150) to comprehensive losses not recognised;

    (b) allocate CU50 of its share of other comprehensive income to comprehensive losses not recognised; and

    (c) recognise its share of the remaining other comprehensive income CU40 in other comprehensive income.

25. Others argue that, in the example in paragraphs 23–24 of this paper, giving priority to the profit or loss would require the investor to allocate CU90 from other comprehensive income to losses not recognised and then CU110 from profit and loss to losses not recognised and recognise CU40 in profit and loss as income from associate A. They would argue this is consistent with the IASB's tentative decision in paragraph 10(c) of this paper because in reducing the carrying amount of the investment to nil the ending point was other comprehensive income.

26. The staff note that applying this alternative would result in some losses never being recognised in profit or loss and therefore the staff prefer the first alternative.

Staff recommendation

27. Whilst acknowledging the two views the staff recommend the IASB proposes that, when applying paragraph 39 of IAS 28, an investor:

    (a) does not separate components of comprehensive income; and

    (b) allocates its share of the associate's profit or loss and then its share of the associate's other comprehensive income to comprehensive losses not recognised.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 27 of this paper?

Separate financial statements–losing control of a subsidiary accounted for using the equity method and retaining an interest in associate

Background

28. Paragraph 9 of IAS 27 *Separate Financial Statements* permits an entity that prepares separate financial statements to account for its investments in subsidiaries, joint ventures and associates either:

    (a) at cost;

    (b) in accordance with IFRS 9 *Financial Instruments*; or

    (c) using the equity method.

29. At its February 2024 meeting[2], the IASB discussed the application question: *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?*

30. The IASB tentatively decided to propose that if a parent entity applies the equity method to its investments in subsidiaries in its separate financial statements, it would apply paragraph 24 of IAS 28 to a step acquisition of a subsidiary. Therefore, the parent does not remeasure the carrying amount of the previously held interest.

Sweep issue

31. A question has been raised on whether the IASB's tentative decision in paragraph 30 of this paper applies if a parent loses control of a subsidiary and retains an interest that is an associate.

[2] See Agenda Paper 13A – Clarifications to the IASB's tentative-decisions of the February 2024 meeting.

Staff analysis

32. In the parent's consolidated financial statements, paragraph B98 of IFRS 10 *Consolidated Financial Statements* requires the parent to recognise the retained investment in the former subsidiary at the fair value at the date when control is lost. In the fact pattern in paragraph 31 of this paper, the parent would remeasure the retained interest in the consolidated financial statements.

33. Paragraph BCZ181 of the Basis for Conclusions on IFRS 10 explains that on loss of control the parent-subsidiary relationship ceases to exist. Therefore, the parent derecognises the individual assets and liabilities related to that subsidiary. Paragraph BCZ182 of the Basis for Conclusions on IFRS 10 explains that the Board decided that any investment the parent has in the former subsidiary after control is lost should be measured at fair value. This decision reflected the Board's view that the loss of control of a subsidiary is a significant economic event.

34. At its February 2024 meeting[3], the IASB observed that if the entity continues to apply the equity method when it gains control of its investment in the associate, there is no basis to require remeasurement of the previously held interest.

35. In the staff's view, the same argument applies to the fact pattern in paragraph 31 of this paper and there is no basis on which to require remeasurement.

Staff recommendation

36. The staff recommend the IASB proposes that a parent entity that applies the equity method to its investment in a subsidiary in its separate financial statements and loses control of that subsidiary, but retains an interest in that former subsidiary that is an associate and continues to apply the equity method, applies paragraph 24 of IAS 28.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 36 of this paper?

[3] See Agenda Paper 13A – Clarifications to the IASB's tentative decisions of the February 2024 meeting.

Profit or loss presentation–gain or loss from a disposal and changes in the fair value of contingent consideration classified as a financial liability

Background

37. Paragraph 32 of IAS 28 requires an investor to include a bargain purchase gain as income in the determination of the entity's share of an associate's profit or loss in the period in which the investment is acquired. In drafting the Exposure Draft, the requirement in paragraph 32 of IAS 28 has been carried forward.

Sweep issue

38. Given the requirement in paragraph 32 of IAS 28, a question has been raised on whether the IASB intends to specify the line item for each item of income and expense that arises when applying equity method, for example:

(a) gains or losses on the disposal or dilution of an ownership interest; and

(b) changes in the fair value of contingent consideration.

Staff analysis

39. The objective of the Equity Method project was to answer application questions. In answering the application question the IASB did not specifically address presentation in the financial statements.

40. Paragraph 53 of IFRS 18 *Presentation and Disclosures in Financial Statements* requires an entity to classify within the investment category income and expenses from associates and joint ventures accounted for using the equity method. Paragraph 54 of IFRS 18 specifies which income and expenses comprise the amounts included in the investing category.

41. Paragraph 75 of IFRS 18 requires an entity to present in the statement of profit or loss a line item for the share of the profit or loss of associates and joint ventures accounted for using the equity method, if it is useful to provide a structured summary. IFRS 18 does not specify in detail which income and expenses are included in the share of profit or loss of associates and joint ventures.

42. IFRS 18 also sets out principles for aggregating and disaggregating assets, liabilities, equity, income and expenses.

43. The staff think the IASB could:

    (a) propose that all income and expenses that arise when applying the equity method should be included in the line item ‘share of the profit or loss of associates and joint ventures accounted for using the equity method’; or

    (b) not specify the line item in which income and expenses that arise when applying the equity method are included. This alternative would rely on the principles for aggregating and disaggregating assets, liabilities, equity, income and expenses.

44. The alternative in paragraph 43(a) of this paper would require the IASB to specify in which line item the income and expense arising from the following IASB’s tentative decisions should be included:

    (a) an investor that disposes of an ownership interest in an associate while retaining significant influence would recognise any difference between the consideration received and the amount of the disposed portion as a gain or lossin profit or loss;

    (b) an investor's ownership interest decreases if its associate issues or redeems equity instruments, and the investor retains significant influence, the investor would recognise that decrease as if disposing of an ownership interest (see paragraph 44(a) of this paper);

(c) an investor recognises the full gain or loss on all transactions with its associates; and

(d) an investor measures contingent consideration (other than contingent consideration classified as equity) at fair value at each reporting date and recognise the changes in profit or loss.

45. If the IASB decided on the alternative in paragraph 43(b) of this paper, then it would need to delete the words '*included as income in the determination of the entity's share of the associate or joint venture's profit or loss'* in paragraph 32 of IAS 28.

Staff recommendation

46. The staff recommend the IASB:

(a) proposes to delete the requirement in paragraph 32 of IAS 28 that specifies the line item in the statement of profit or loss in which an investor includes a bargain purchase gain in the period it acquires the investment ('*included as income in the determination of the entity's share of the associate or joint venture's profit or loss*'); and

(b) not specify the line item in the statement of profit or loss in which an investor includes income and expenses that arise when applying the equity method.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 46 of this paper?

Disclosure–contingent consideration on purchase of an additional interest

Background

47. At its September 2023 meeting[4], the IASB tentatively decided to propose an investor disclose, for contingent consideration arrangements:

(a) *on obtaining significant influence in an associate*—the amount recognised at the acquisition date; a description of the arrangement and the basis for determining the amount of the payment; and an estimate of the range of outcomes (undiscounted); and

(b) *for each reporting period after the acquisition date until the investor collects or settles the contingent consideration or it is cancelled or expires*—any changes in the recognised amounts, including any differences arising upon settlement; any changes in the range of outcomes (undiscounted) and the reasons for those changes; and the valuation techniques and key model inputs used to measure the contingent consideration.

Sweep issue

48. In drafting the pre-ballot draft the staff noted the IASB's tentative decision in paragraph 47 of this paper did not extend to contingent consideration for the purchase of an additional interest in an associate or joint venture.

[4] See Agenda Paper 13C – Possible improvements to disclosure requirements for investments in associates of the September 2023 meeting.

Staff analysis

49. The IASB's tentative decisions on contingent consideration are aligned to the requirements for contingent consideration in IFRS 3 *Business Combinations*. The information required by paragraphs B64 and B67 of IFRS 3 is helpful in assessing the amount, timing and uncertainty of the entity's future cash flows which applies equally to associate entities. Furthermore, the disclosures are consistent with the objective in paragraph 20(b) of IFRS 12—to disclose information that enables users to evaluate the nature of, and changes in, the risks associated with the interest in associates.

50. The staff note:

    (a) the IASB agreed that the recognition, measurement and disclosure requirements for contingent consideration are also useful in relation to contingent consideration for the purchase of an associate; and

    (b) the IASB agreed that the recognition and measurement requirements for contingent consideration for the purchase of an associate are also useful in relation to contingent consideration for the purchase of an additional interest in an associate.

Staff recommendation

51. Based on the analysis in paragraphs 49–50 of this paper, in the staff's view the same disclosure requirements should be required for contingent consideration for the purchase of an additional interest in an associate. Consequently, the staff recommend the IASB proposes that an investor provides the same disclosures for contingent consideration for the purchase of an additional interest in an associate, as the investor does for the purchase of an associate.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 51 of this paper?

Transition–contingent consideration classified as equity instruments

Background

52. At its June 2023 meeting[5], the IASB discussed the application question: *How to, initially and subsequently, recognise and measure contingent consideration on acquisition of an investment in an associate*?

53. The IASB tentatively decided that an investor would recognise contingent consideration as part of the consideration transferred and measure that contingent consideration at fair value. The investor would classify:

    (a) an obligation to pay contingent consideration that meets the definition of a 'financial instrument' as a financial liability or as an equity instrument on the basis of the definitions of a financial liability and an equity instrument in accordance with paragraph 11 of IAS 32 *Financial Instruments: Presentation*.

    (b) a right to the return of previously transferred consideration as an asset.

54. Subsequently the investor would:

    (a) for contingent consideration classified as an equity instrument, not remeasure that contingent consideration and recognise its subsequent settlement within its equity; and

    (b) for other contingent consideration, measure that contingent consideration at fair value at each subsequent reporting date and recognise changes in fair value in its statement of profit or loss.

[5] See Agenda Paper 13B – Contingent consideration on acquisition of an investment in an associate, including subsequent measurement of the June 2023 meeting.

55. At its November 2023 meeting[6], the IASB discussed the transition provisions. The IASB tentatively decided that an investor would recognise and measure contingent consideration at fair value at the transition date. The investor would recognise any corresponding adjustment to the carrying amount of its investments in associates.

Sweep issue

56. One of the reviewers on the pre-ballot draft noted that, if an investor has classified that contingent consideration as a financial liability and the investor has an accounting policy that is consistent with the IASB's tentative decision on contingent consideration on transition it would not be required to remeasure that contingent consideration.

Staff analysis

57. If an investor has recognised and classified contingent consideration as an equity instrument and the investor measured that equity instrument at fair value at the date significant influence was obtained, applying the proposed transition requirements would require the investor to remeasure the amount recognised as equity to fair value at the transition date. In the staff's view this is not the correct outcome because an entity should not be required to remeasure amounts in equity.

Staff recommendation

58. The staff recommend the IASB proposes that, if an investor has recognised contingent consideration as an equity instrument and the investor measured that equity instrument at fair value at the date it obtained significant influence (or, for contingent consideration for the purchase of an additional interest, carried at the fair value at the date of the purchase), the investor does not remeasure that contingent consideration.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 58 of this paper?

[6] See Agenda Paper 13B – Transitional provisions of the November 2023 meeting.