STAFF PAPER

1 – 2 October 2015

Accounting Standards Advisory Forum

Project	The Equity Method of Accounting		
Paper topic	Proposal to amend the Equity Method of Accounting		

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41. Sitzung IFRS-FA am 04.09.2015
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Objective—advice sought from ASAF

1. At this meeting, we would like to seek the views of the ASAF's members on the IASB staff's preliminary proposals to amend the equity method of accounting. The staff intend to propose that as part of the Equity Method of Accounting project, the IASB should seek views on whether to retain the requirements in IAS 28 *Investments in Associates and Joint Ventures*:

   (a) for an entity to account for the difference between (i) the cost of the investment and (ii) the entity's share of the net fair values of the investee's identifiable assets and labilities as either goodwill (where (i) exceeds (ii)) or income (where (ii) exceeds (i)); and

   (b) that gains or losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associates or joint ventures should be recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or the joint venture. In other words, the entity's share of those gains or losses resulting from 'upstream' and 'downstream' transactions should be eliminated.

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Background

2. At the ASAF meeting in March 2015 the IASB staff presented a proposal to divide the Equity Method of Accounting Project into two phases. We received mixed responses from ASAF members on the proposal. Having taken the views of the ASAF members into consideration, the IASB staff presented an alternative proposal to the IASB at its meeting in June 2015.
3. The IASB supported the staff's alternative proposal to undertake a limited-scope research project that seeks to address application problems arising from the equity method requirements in IAS 28. Appendix A of this paper sets out a summary of the project's approach, including the IASB's tentative decisions from the June 2015 meeting.
4. Having obtained the IASB's support to undertake the limited-scope research project, the staff are currently considering the equity method of accounting as set out in IAS 28. The aim of this analysis is to consider possible approaches that seek to address the application problems that have been identified with that methodology.
5. The topics discussed in this paper include:

Accounting on acquisition

(a) Cost of investment (paragraphs 6-14);

(b) The requirement on acquisition for an entity to measure its share of the investee's identifiable assets and liabilities at fair value (paragraphs 150-37);

(c) Bargain purchase (paragraphs 38-39); and

Subsequent accounting

(d) Transactions between the investor and investee (paragraphs 40-63).

6. Other topics that are planned to be discussed with the IASB over the coming months include:

   (a) Accounting for the changes in ownership;

   (b) The requirement to apply uniform accounting policies for like transactions and events in similar circumstances;

   (c) Accounting where the investor and investee have non-coterminous reporting periods;

   (d) How the impairment test should be applied when the equity method is used; and

   (e) Application of the equity method to subsidiaries.

7. The discussion on the topics planned for future IASB meetings may inform the topics discussed in this paper and therefore lead to further refinement/discussion of these topics. Specifically, the requirement for consistent accounting policies is related to the discussion on the requirement on acquisition for an entity to measure its share investee's identifiable assets and liabilities at fair value.

8. At present the equity method of accounting is applied to all investments in entities that are associates or joint ventures. The staff consider that in discussing possible changes to the equity method of accounting as set out in IAS 28, it is also necessary to consider whether any revised/amended equity method would be the appropriate method for all investments in associate entities and joint venture entities.

9. The views of the ASAF members are being sought in advance of discussions with the IASB; hence, the proposals set out in this paper are preliminary staff proposals.

Accounting on acquisition

Cost of investment

10. Paragraph 10 of IAS 28 provides that on initial recognition, the investment in an associate or a joint venture is recognised at cost. IAS 28 does not define the cost; however, in other Standards cost generally includes the purchase price and other costs directly attributable to the acquisition. The inclusion of other directly

attributable costs in the purchase price contrasts with paragraph 37 of IFRS 3 *Business Combinations*, which provides:

> The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to the former owners of the acquiree and the equity interests issued by the acquirer.

11. In contrast, paragraph 5.1.1 of IFRS 9 *Financial Instruments* provides:

> … at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

12. As a consequence, on initial recognition:

    (a) financial assets and financial liabilities are measured at fair value plus or minus, in the cases of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the issue of the financial asset or financial liability;

    (b) associate and joint venture entities accounted for in accordance with IAS 28 are measured at cost; and

    (c) the consideration transferred in a business combination is measured at fair value in accordance with IFRS 3.

13. Paragraph 5.1.1A of IFRS 9 provides that if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply paragraph B5.1.2A. Paragraph B5.1.2A limits the circumstances in which a gain or a loss can be recognised when the fair value and the transaction price differ.

14. The staff have not identified any concern about the application of cost in accordance with IAS 28. However, at present, an entity recognises the difference

between the cost of the investment and entity's share of the net fair values of the investee's identifiable assets and labilities as either goodwill (where the cost of the investment exceeds the entity's share of the net fair values of the investee's identifiable assets and liabilities) or income (where the entity's share of their net fair values exceeds the cost of the investment). In the following section we consider whether the requirement for an entity to measure its share of the net fair values of the investee's identifiable assets and labilities should be retained. If this requirement is not retained, the requirement to compare that amount with the cost of the investment will not be retained. In the staff's view, removing that requirement would reduce the likelihood of a gain arising on acquisition; see paragraph 35.

Fair value of the entity's share of the investee's identifiable assets and liabilities

15. Paragraph 32 of IAS 28 requires any difference between (i) the cost of the investment and (ii) the entity's share of the net fair values of the investee's identifiable assets and labilities to be accounted for as:
    (a) goodwill, if (i) exceeds (ii). This goodwill is included in the carrying amount of the investment. Amortisation of the goodwill is not permitted.
    (b) income, if (ii) exceeds (i).
16. Paragraph 32 of IAS 28 also requires adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition to account, for example, for depreciation of depreciable assets at their fair value at the acquisition date.
17. We have also received feedback that it is sometimes difficult to obtain information required to prepare the fair value adjustments when applying the equity method of accounting. This can happen if an investor does not control an investee and therefore does not have unrestricted access to information.
18. The following paragraphs consider the basis of the requirement for an entity on acquisition to measure an investee's identifiable assets and labilities at fair value.
19. Paragraph BC203 to IFRS 3 notes that:

> The boards concluded that measuring assets acquired or liabilities assumed at amounts other than fair values at the

> acquisition date does not faithfully represent their economic values or the acquirer's economic circumstances resulting from the business combination.

20. Paragraph BC203 of IFRS 3 further notes that:

> The boards concluded that measurement at fair value enables users to make a better assessment of the cash-generating abilities of the identifiable net assets acquired in the business combination and the accountability of management for the resources entrusted to it.

21. The requirement to measure the identifiable net assets acquired in a business combination at fair value aims to present faithfully the economic values of the net assets acquired. By measuring assets and liabilities acquired at fair value on acquisition, it is anticipated that users can make a better assessment of the cash-generating abilities of the identifiable net assets acquired. If there were no requirement to measure the identifiable net assets acquired in a business combination at fair value, then consolidated financial statements would, most likely, include the net identifiable assets at the amounts previously presented in the vendor's financial statements (carryover value) [1]. Consequently, the consolidated financial statements would, most likely, present the assets at the cost to the vendor rather than at the cost to the acquirer.

22. On the acquisition of a subsidiary, a parent entity obtains control over the assets and liabilities and separately recognises those assets and liabilities in the consolidated financial statements. However, when an entity acquires a significant interest or obtains joint control it has not obtained control over the individual assets or liabilities and does not separately recognise the individual assets and liabilities. The equity method of accounting does not require the individual assets and liabilities to be presented separately, nor does it require separate disclosure of the goodwill attributable to investment.

23. There is therefore a question as to the objective of the requirement on acquisition for an entity to measure its share of the investee's identifiable assets and liabilities

[1] The carryover value is the amount reported by the investee in its financial statements for the assets and liabilities.

at fair value. IAS 28 does not explain the rationale for this requirement; it does note that many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures applied in IFRS 10 *Consolidated Financial Statements*.

24. The project approach set out in Appendix A of this paper, notes that the IASB has tentatively decided that the unit of account for equity-accounted-for investments is the investment as a whole. In other words, the investment is a single asset. The equity method of accounting recognises an investor's interest in an associate or joint venture as a single asset—the investor controls its interest in the associate or joint venture but does not control its share of the associate's underlying assets or liabilities.

25. In the absence of a clear understanding of the objective for the requirement on acquisition for an entity to measure its share investee's identifiable assets and liabilities at fair value, and given the feedback received as part of this project, we propose to recommend to the IASB that it should seek views on whether to retain this requirement.

26. In June 2015 the FASB published an Exposure Draft *Investments—Equity Method and Joint Ventures Simplifying the Equity Method of Accounting* ('the FASB ED'). The proposals set out in the FASB ED include eliminating the requirement for an entity to measure its share of the investee's identifiable assets and labilities at fair value. US GAAP refers to this as the 'basis difference'. The basis difference is the difference between the cost of an investment and the investor's proportional share of the fair value of an investee's assets and liabilities.

27. Current US GAAP requires an investor to:

    (a) recognise the investment at cost and determine the acquisition date fair value of the identifiable assets and liabilities. In subsequent accounting periods an investor would amortise, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment. This would include adjustments to an investor's share of the profit and loss of the investee for depreciable assets whose fair value at acquisition was higher than carrying value in the investee financial statements;

(b) similarly, an investor would adjust the gain on disposal to reflect the fair value of the assets at acquisition less the depreciation/amortisation; and

(c) amortise the basis difference.

Performance reporting

28. The staff have reviewed some of the early comment letters responding to the FASB ED and note respondents have raised a concern regarding the effect on performance reporting arising from the FASB's proposals. The concerns include:

(a) higher profits would be reported in the post-acquisition period, because the investor would no longer be required to adjust its share of the profits of the investee in the post-acquisition period for any additional depreciation/amortisation on depreciable assets whose fair value at acquisition was higher than carrying value in the investee financial statements;

(b) similarly, higher profits are also reported in the post-acquisition period when an asset is subsequently disposed of, because the investor is not required to adjust the gain on disposal to reflect the fair value of the asset at acquisition less the depreciation/amortisation; and

(c) as a consequence of (a) and (b), higher income is recognised and the cost of the investment is increased. This increases the probability of an impairment loss.

29. In Appendix B of this paper, the staff have attempted to illustrate the effect of not retaining the requirement on acquisition for an entity to fair value its share investee's identifiable assets and liabilities.

30. Some respondents to the FASB ED stated that the proposed accounting creates a disconnection between financial reporting and economic reality. In these respondents' view, if the disposal of the assets had been contemplated at acquisition, recognising the 'full gain' on disposal overstates the profits attributable to the investor—they seem to argue the gain is a return ***of*** the investment instead of a return ***on*** the investment.

31. The staff do not support the view that recognition of the full gain on disposal overstates the profits attributable to the investor. The example in Appendix B illustrates that the difference between cost of the investment less the investor's proportionate share of investee's net assets at carryover value (we have used the term purchase price premium to describe this difference) is constant both before and after the disposal of the assets.

32. The purchase price premium is constant because after the investee has disposed of the assets, it holds cash (or other assets) in replacement for those assets. Because the investee holds cash (or other assets) in replacement for the disposed assets, there has not been a return ***of*** the investment. It does not automatically follow that there is an impairment to the original cost of the investment. The investee either reinvests the cash or returns the cash to shareholders.

33. To consider this point we have reproduced the reconciliation of the net assets of the associate to the investor's carrying value of the investment in the table below:

	IAS 28 CU[2]	**No requirement to fair value CU**
Acquisition accounting		
Proportionate interest in assets less liabilities (CU90,000 × 0.3)	27,000	27,000
Share of fair value difference on property, plant and equipment (CU10,000 × 0.3)	3,000	-
Share of goodwill on acquisition	5,000	-
Purchase price premium	-	8,000
Acquisition price	35,000	35,000
20X4 net assets of investee	95,000	95,000
30 per cent share of net assets	28,500	28,500
Purchase price premium	-	8,000
Goodwill	5,000	
Share of fair value difference on property, plant and equipment less depreciation	2,700	-
Unrealised profit	(60)	-
	36,140	36,500

[2] In this paper, currency amounts are denominated in 'currency units' (CU).

20X5 net assets of investee	109,000	109,000
30 per cent share of net assets	32,700	32,700
Purchase price premium	-	8,000
Goodwill	5,000	-
	37,700	40,700

34. The table helps to demonstrate that, in accordance with current IAS 28, when an associate entity disposes of assets, where the fair value at acquisition for the assets disposed of was higher than the carrying amount in the associate's financial statements, the investor eliminates from its cost of the investment the fair value difference on acquisition for the assets disposed of. The investor, however, has not altered its investment in the investee, but now reports a lower cost of investment. As a consequence, in future the investor will report a higher return on the investment.

35. Some argue that not eliminating the fair value difference from the cost of the investment results in double counting, because the investor's purchase price took into consideration the unrecorded gain. The investee has recognised the unrecorded gain that already existed when the investor acquired its holding in the investee. By the investee recognising the gain and the investor not eliminating the fair value difference from cost of the investment there is 'double counting'. The staff does not support this view because the investee now holds cash (or other assets) rather than there being an unrecognised gain. The staff also consider that not eliminating the fair value difference from the cost of investment is a better assessment of the accountability of management for the resources entrusted to it.

Risk of impairment

36. The staff have some sympathy with the comments regarding an increased risk to impairment made by FASB respondents to the ED. As noted above higher profits are reported in the post-acquisition period because the investor is not required to adjusted its share of the profits (including gains of disposal of assets) of the investee in the post-acquisition period for any additional depreciation/amortisation on depreciable assets whose fair value at acquisition was higher than carrying value in the investee financial statements.

37. The staff accept that there is an increase in the risk of impairment as the carrying amount of the investment increases.

Question 1
The staff will propose to the IASB that it should seek views on whether to retain the requirement in IAS 28 to account for the difference between the cost of the investment and the entity's share of the net fair values of the investee's identifiable assets and labilities as either goodwill or income. Do ASAF members have comments on the staff analysis?

Bargain purchase

38. As noted, if the requirement to measure the fair value the investor's share of the investee's assets and labilities is not retained, then the likelihood of a gain arising on acquisition of the investee is reduced. This is because, in accordance with IAS 28, a gain is recognised when there is an excess in the entity's share of the net fair value of the investee's identifiable assets and labilities over the cost of the investment (ie when there is a bargain purchase). If there is no requirement to measure the investor's share of the fair value of the assets and liabilities at acquisition then it is unlikely that a bargain purchase will be identified. A bargain purchase will only be identified where the cost of the investment is less than the entity's share of the carrying amounts in the investee's financial statements.

39. The staff have not identified any concern about the requirement to recognise a gain when a bargain purchase occurs.

Transactions between the investor and investee

40. Paragraph 10 of IAS 28 notes that the carrying amount of the investment is increased or decreased in order to recognise the investor's share of the profit or loss of the investee after the date of acquisition.

41. Paragraph 28 of IAS 28 further provides that gains or losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associates or joint ventures are recognised in the

entity's financial statements only to the extent of unrelated investors' interests in the associate or the joint venture. In other words, gains and losses between an investor and its associates and joint ventures are eliminated (elimination entries).

Accessing information

42. In November 2014, we discussed the equity method and application issues with the Global Preparers Forum (GPF). GPF members explained that it is often difficult to obtain information required for the equity method of accounting. They noted that complications arise if gains and losses from upstream and downstream transactions ('elimination entries') are required.

43. GPF members further explained that when there is joint control or significant influence, there is little ability to generate profits that are not arm's length, because prices have to be agreed with the joint venture partner or other investors in the associate. GPF members explained that there is a step change in the relationship between (a) control and (b) joint control or significant influence. In the circumstances of joint control or significant influence, GPF members consider that prices are negotiated on an arm's length basis.

The role of elimination entries

44. When the IASB discussed the scope of the Equity Method of Accounting research project in May 2014 it was noted that:

> Elimination entries in the preparation of consolidated financial statements ensure that the consolidated financial statements show the result of the parent entity and the entities that it controls as a single economic entity. The same cannot be said when the equity method of accounting is applied, as associate and joint venture entities are not controlled by the parent and are therefore outside the single economic entity.

45. In consolidated financial statements, elimination entries remove profits that have not been earned by the group (as a single economic entity) because the transaction

has not taken place outside the group. The objective of eliminating entries is clear for the purposes of accounting for subsidiaries in consolidated financial statements.

46. The debate as to the role of elimination entries when applied to associate and joint venture entities is less clear. IAS 28 does not identify whether the equity method is a consolidation method or a measurement method. If the method is applied as a consolidation method, it follows that gains and losses on upstream and downstream transactions should be eliminated. In this instance, the objective of elimination entries is consistent with the objective for subsidiaries that form part of the group.

47. In contrast, if the equity method is applied as a measurement method it is more challenging to identify why gains and losses are eliminated. The equity method of accounting is being applied to investments outside the group; consequently, by definition the transaction has taken place outside the group and the reasons that existed in consolidated financial statements to eliminate the gain or loss no longer exist.

48. Because we do not have a clear understanding of the role of elimination entries, it is appropriate to consider the *Conceptual Framework*:

    (a) paragraph OB2 of the *Conceptual Framework* provides that:

    > The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

    (b) paragraph QC2 of the *Conceptual Framework* provides that:

    > Financial reports provide information about the reporting entity's economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims.

    (c) paragraph OB4 of the *Conceptual Framework* identifies that:

    > To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of an entity, claims against the entity, and how efficiently and effectively the

entity's management and governing board have discharged their responsibilities to use the entity's resources.

(d) paragraph 4.24 of the *Conceptual Framework* provides that:

Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share.

49. The staff also consider that paragraph 7.20 of the *Conceptual Framework* ED is helpful in considering performance. Paragraph 7.20 provides that:

The purpose of the statement of profit or loss is to:

(a) depict the return that an entity has made on its economic resources during the period; and

(b) provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of an entity's resources.

50. Depicting the return that an entity has made on its economic resources is central to the equity method of accounting. The equity method recognises that for associate and joint venture entities, the recognition of dividend income alone may not reflect the return on the investment (that is the economic resource) and is therefore not an adequate performance measure.

51. The following table summarises the profit in the illustrative examples set out in Appendix B:

Share of associates income	**20X4 CU**	**20X5 CU**
Current IAS 28	3,240	3,660
Proposal	3,600	6,300

53. In both years profit is higher because there is no requirement:

    (a) to recognise the investor's share of assets and liabilities at fair value on acquisition is eliminated; consequently, there is a lower depreciation charge in the post-acquisition period; and

    (b) to eliminate gains and losses between an investor and its associates .

54. The current requirements of IAS 28 provide a measure of the investor's share of the investee's profits. In essence IAS 28 provides a measure of the profit that the investor would have reported if the investor had entered into the transaction, ie as if the *investor had control of its share of the underlying assets and liabilities*.

55. Alternatively, if there is no requirement to adjust earnings in the post-acquisition period the profit provides a measure of the investor's share of the post-acquisition profit as *reported by the investee*. The question that we need to answer is: which of the methods provides information that is helpful in assessing prospects for future cash flows and in assessing an entity's management of its resources?

56. While removing the requirement to make elimination entries would address some of the application concerns of preparers, it has been argued that without the requirement to eliminate upstream and downstream transactions it is possible for an entity to manage its earnings. For example, the entity could sell products to an associate at a profit and, without the requirement to eliminate the entity's share of the profit, the profit and loss is overstated.

57. However, as noted, this viewpoint was not supported by GPF members who stated that in the circumstance of joint control or significant influence, prices are negotiated on an arm's length basis.

58. A possible solution to the concern about earnings management, but still seeking to address the GPF's concerns about practicality, is to require elimination entries in situations in which the transactions are not at fair value.[3] The staff do not consider that this would be a popular option, because it is probably an anti-avoidance measure. In addition, it may be difficult to identify whether the transaction is at fair value and therefore the proposal might be difficult to implement.

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[3] Defined in accordance with IFRS 13 *Fair Value Measurement*—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.

59. An alternative proposal could be to provide additional related party disclosures that provide disclosures regarding the extent of 'upstream' and 'downstream' transactions.

60. It is also possible that the need for elimination entries does not apply equally to all investments that are accounted for using the equity method. GPF members noted, for example, that application of the equity method of accounting was useful where the business model means that operations of the investee are 'embedded' within the operations of the investors. In contrast, the equity method may not be appropriate if the holding is temporary or not held for the principal purpose of the business. The staff plan to discuss this issue further after they have considered the methodology of the equity method.

61. The staff also think that we need to discuss the performance reporting matters with the Capital Markets Advisory Committee to understand users' views on performance measures.

Application issues

62. The objective of this project is to address application problems[4] with the equity method of accounting. Application issues identified include the elimination of gains or losses arising from transactions between an entity and its associate or joint venture; however, the transactions identified often involve changes in ownership.

63. The staff consider that further discussion on whether to retain the requirement to elimination of upstream and downstream transactions that involve changes in ownership requires separate consideration. This is because the discussion needs to include a discussion of how the retained interest should be measured.

[4] A list of Application issues is set out in the June 2015 IASB Agenda Paper 13, Appendix C.

Question 2

The staff will propose to the IASB that it should seek views on whether an entity's share of gains or losses resulting from 'upstream' and 'downstream' transactions between an investee and investor should be eliminated.

Do ASAF members have comments on the staff analysis?

Equity Method of Accounting—project approach	
Project objective	To address application problems with the equity method of accounting as set out in IAS 28 *Investments in Associates and Joint Ventures* for joint ventures and associate entities and to consider separately the role of the equity method in separate financial statements for subsidiaries.
Current status	On 24 June 2015 the IASB tentatively decided to split the existing project into two parts: (a) a limited-scope research project that aims to: i) address application problems[5] with the equity method as set out in IAS 28, including the matters currently being considered by the Interpretations Committee on developing a narrow-scope amendments to IAS 28; and ii) assess separately the equity method of accounting as applied to subsidiaries in separate financial statements. (b) a longer-term project to consider the need for a more fundamental review of the equity method of accounting, which will not begin until after completion of the Post-implementation Reviews of IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities*.
Next steps	
Focus of the next months	Developing the methodology based on the proposed assumptions and conduct further outreach. At its meeting in June 2015 the IASB tentatively decided: (a) to undertake a limited-scope research project that seeks to address application problems arising from the equity method requirements IAS 28. (b) that the methodology for the limited-scope research project should assume that: (i) control is the appropriate basis for determining the reporting group; and (ii) associate and joint venture entities are not part of the group and therefore their assets and liabilities should not be recognised separately in the financial statements. (c) the unit of account is the investment as a whole. (d) the limited-scope project should seek to address the matters currently being considered by the Interpretations Committee in developing a narrow-scope amendments to IAS 28. The application date of *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (Amendments to IFRS 10 and IAS 28), issued in September 2014, will be deferred. (e) to assess separately the equity method of accounting as applied to subsidiaries in separate financial statements. (f) to review the implications of proposals arising from the project on the application of the equity method to joint venture entities and/or associate entities. (g) to consider the need for a wider research project on the equity method of accounting after completion of the Post-implementation Reviews of IFRS 10, IFRS 11 and IFRS 12.

[5] A list of Application issues is set out in the June 2015 IASB Agenda Paper 13, Appendix C.

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Next milestone	
Next planned publication	This will depend on the progress of the IASB's deliberations but is expected to be a Discussion Paper in 2016.
Target date	Discussion Paper in first half of 2016.

Equity method example

Acquisition

On 1 January 20X4 Investor Entity purchases 30 per cent of the ordinary shares (common stock) of Investee Entity for CU35,000 in cash. Investor Entity has the ability to exercise significant influence over Investee Entity and therefore applies the equity method of accounting.

	CU
Investee entity	
Financial position at 1 January 20X4	
Property, plant and equipment	76,000
Financial assets	24,000
Liabilities	(10,000)
	90,000
Equity (common shares)	90,000

The entry to account for the acquisition is:

Dr.	Investment in Investee Entity	35,000
Cr.	Cash	35,000

The requirements in IAS 28 mean that Investor Entity will need to track any differences between its proportionate interest in the carrying amount of Investee Entity at the date it acquired its interest and the amount it paid at that date.

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An independent valuation report states that the fair value of the property, plant and equipment is CU86,000 at the acquisition date. The financial assets and liabilities are already at fair value. Accordingly, the acquisition can be analysed, for the purposes of IAS 28, as follows:

Proportionate interest in assets less liabilities (CU90,000 × 0.3)	27,000
Share of fair value difference on property, plant and equipment (CU10,000 × 0.3)	3,000
Share of goodwill on acquisition	5,000
Acquisition price	35,000

The fair value difference on the property, plant and equipment will be used to adjust the depreciation when the equity earnings are calculated.

The share of goodwill needs to be tracked in case there is an impairment of the investment.

2014 - Post-acquisition activities

During 20X4 Investee Entity reports a profit of CU12,000. During the year Investee Entity paid a total dividend of CU7,000. There are no other changes to equity (net assets).

The property, plant and equipment is depreciated on a straight-line basis. At the time of the acquisition, Investor Entity assessed that a remaining 10-year life, to a nil residual value, was appropriate.

During the year Investor Entity sold inventory to Investee Entity. At the end of the year the Investee Entity was holding inventory for sale that it acquired from Investor Entity. Investee Entity paid CU300 for the inventory, which originally cost Investor Entity CU100.

Recording the dividend

IAS 28 states that the equity method requires that dividends received reduce the carrying amount of the investment. Hence, the IAS 28 treatment is:

Dr. Cash	2,100
Cr. Investment in Investee Entity	2,100

Recording the investor's equity income:

Share of profit (unadjusted) (CU12,000 × 30%)	3,600
Depreciation adjustment (3,000 ÷ 10)	(300)
Unrealised inventory adjustment	(60)
IAS 28 equity income	3,240

	IAS 28	No requirement to fair value
Reconciliation of investor's carrying amount to net assets of the investee		
Cost	35,000	35,000
Adjusted earnings	3,240	3,600
Dividend	(2,100)	(2,100)
In consequence, the net carrying amount at the end of 20X4 would be:	36,140	36,500
Net assets of investee		
Net assets at acquisition, in investee's financial statements	90,000	90,000
Profit for year less dividend	5,000	5,000
Net assets at end of 20X4, in investee's financial statements	95,000	95,000

30 per cent share of net assets	28,500	28,500
Purchase price premium (cost less investor's proportionate share of investee's net assets)	-	8,000
Goodwill	5,000	-
Share of fair value difference on property, plant and equipment less depreciation	2,700	-
Unrealised profit	(60)	-
	36,140	36,500

20x5 - Disposal of assets

In 20X5 Investee Entity reports a profit of CU21,000, which includes a profit of CU14,000 on disposal of all the property, plant and equipment acquired at acquisition. Investee Entity pays a dividend of CU7,000.

During 20X5 the Investee Entity sells the inventory purchased from the investor in 20X4.

Recording the dividend

As in 20X4 the dividend is recorded against the costs of the investment.

Dr Cash and cash equivalents	2,100
Cr Investment in Investee Entity	2,100

Recording the investor's equity income:

Share of profit (unadjusted) (CU21,000 × 0.3)	6,300
Adjustment for profit of disposal of fixed assets (CU3,000 – CU300)	(2,700)
Realisation of previously unrealised profits	60
IAS 28 equity income	3,660

	IAS 28	No requirement to fair value
Reconciliation of investor's carrying amount to net assets of the investee		
Carrying amount from 20X4	36,140	36,500
Share of profit (adjusted)	3,660	6,300
Dividend	(2,100)	(2,100)
In consequence, the carrying amount at the end of 20X5 would be:	37,700	40,700
Net assets of investee		
Net assets at acquisition, in investee's financial statements	90,000	90,000
Profit for year less dividend 20X4	5,000	5,000
Profit for year less dividend 20X5	14,000	14,000
Net assets at end of 20X5, in investee's financial statements	109,000	109,000

Share of net assets	32,700	32,700
Purchase price premium	-	8,000
Goodwill	5,000	-
Carrying amount	37,700	40,700