IAS 28: Equity Method Accounting on an Investment in Common and Preferred Shares

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Under IAS 28 *Investments in Associates and Joint Ventures*, an investment in an associate or a joint venture is accounted for using the equity method of accounting. Using this method, an investment in an associate or a joint venture is initially measured at cost. Subsequently, the carrying amount is increased or decreased to recognize the investor's share of the profit or loss of the investee after the acquisition date.

Per paragraph 12 of IAS 28, “When potential voting rights or other derivatives containing potential voting rights exist, an entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments.” However, paragraph 13 of IAS 28 states: “In some circumstances, an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the returns.” IAS 28 does not specify the types of instruments that the entity may consider as in-substance existing ownership interests.

The Group considered the following fact patterns and discussed how an investor’s share of the investee’s income or loss should be calculated under the equity method when the investment includes both voting common shares and non-voting preferred shares of the investee.

Fact Pattern for Issue 1

- Company A holds a combination of common shares and preferred shares in Company B. Company A has 20 per cent voting rights of Company B through its investment in common shares.
- The preferred shares are non-voting but are convertible into common shares on a one-to-one basis at the option of the holder. If all its preferred shares are converted, Company A will increase its voting rights of Company B to 30 per cent.
- The preferred shareholders are not obligated to fund Company B’s losses. They have no liquidation preferences or preference in the event of distribution. Distributions are at Company B’s discretion. If a preference dividend is declared, it is calculated based on a percentage of Company B’s available profits.
- Assume all other facts and circumstances support Company A having significant influence over Company B and Company A does not control Company B.

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Issue 1: Should Company A's share of investment income or loss using the equity method include the preference shares held in Company B?

View 1A – No, the preferred shares should not be included when calculating Company A's share of investment income or loss in Company B

- Proponents of this view think the preferred shares do not represent existing ownership rights for the following reasons:
  - (a) Preferred shareholders are not obligated to fund losses of investees. Therefore, they are limited in their exposure to Company B's losses;
  - (b) The value of preferred shares generally does not fluctuate significantly based on the market value of the entity. Therefore, the preferred shareholders are shielded from direct exposure to gains or losses on their investment or fluctuations in fair value in Company B's net assets, except in the event of liquidation; and,
  - (c) Given a lack of guidance on what constitutes exposure to investee's rights to profit or losses in IFRS, it is unclear whether the exposure to discretionary dividend income or potential exposure to a liquidation event is sufficient to qualify these preferred shares as existing ownership.
- Therefore, proponents of this view think the preferred shares do not represent existing ownership rights and should not be included when calculating Company A's share of investment income or loss in Company B.

View 1B – Yes, the preferred shares should be included when calculating Company A's share of investment income or loss in Company B

- Proponents of this view considered the common shares that can be converted from preferred shares at the option of the holder. They note these common shares can give Company A additional voting power and can create exposure to Company B's profit and losses. Furthermore, the lack of protection in the event of liquidation exposes Company A to a potential loss of investment in Company B.
- As such, Company A's exposure to Company B's profit, losses, and fluctuations in fair value of net assets provides, in combination with other rights, present ownership interest in Company B. Therefore, proponents of this view think these preferred shares should be included when calculating Company A's share of investment income or loss in Company B.

The Group's Discussion

Group members offered different views on this issue.

Most Group members supported View 1A. In reaching this conclusion, these Group members cited the non-voting feature of preferred shares and the resulting inability to influence the investee to distribute returns as being important to their decision. They thought that given Company B has discretion to distribute profits, the preferred shareholders cannot influence Company B in making the distribution decision. As such, preferred shares do not give their holders access to Company B's returns and are not an in-substance existing ownership in Company B as described in paragraph 13 of IAS 28. Considering paragraph 12 of IAS 28, only Company A's common share interests should be considered when calculating Company A's share of investment income or loss in Company B. Some Group members also questioned whether the preferred shares are akin to common shares as it is unclear whether any profit from Company B will be distributed to preferred shareholders considering the preference dividends are not mandatory or cumulative and may not be paid in the event of liquidation.

Some Group members preferred View 1B. These Group members considered the voting rights to be a separate issue. They viewed the preferred shares as economically similar to the common shares based on the features described in the fact pattern, such as no liquidation preference, similar subordination and rights to a percentage of Company B's profits. Given this similar economic exposure, they thought the preferred shares should be included when calculating Company A's share of investment income or loss in Company B.

One Group member also commented that there are two distinct assessments of potential voting rights in the analysis:

- the assessment of whether potential voting rights contribute to significant influence; and
- whether potential voting rights should be considered an existing ownership under the equity method of accounting.

This Group member noted that the potential voting rights in preferred shares may contribute to an entity having significant influence over an investee. However, it does not automatically mean that the preferred shares are existing ownership interests to be included in the calculation of the investor's share in its investee's income or loss.

Fact Pattern for Issue 2

Similar to Fact Pattern for Issue 1, except the shareholders agreement for the preferred shares contains the following terms:

(a) a liquidation preference over common shareholders as first-priority,

(b) non-redeemable but require annual dividend payments based on a set coupon rate. There is no provision for discretionary dividends,

(c) convertible into common shares on a one-to-one basis at the option of the holder,

(d) non-voting but once converted into common shares, each common share is entitled to one vote, and

(e) no redemption clauses, other than for liquidation events

Issue 2: Based on this revised fact pattern, should Company A's share of investment income or loss using the equity method include the preference shares held in Company B?

View 2A – No, the preferred shares should not be included when calculating Company A's share of investment income or loss in Company B

- Proponents of this view think the preferred shares do not represent existing ownership rights for the following reasons:
  (a) Preferred shares have priority on distributions and payments on liquidation over common shareholders, which limits a preferred shareholder's exposure to Company B's losses as the initial investment is recovered as the first priority;
  (b) Preferred shareholders are not obligated to fund losses of investees; and
  (c) Contractual distributions or payments on liquidation to preferred shareholders are not affected or reduced as a result of losses by Company B.
- Therefore, proponents of this view think the preferred shares do not represent existing ownership rights and should not be included when calculating Company A's share of investment income or loss in Company B.

View 2B – Yes, the preferred shares should be included when calculating Company A's share of investment income or loss in Company B

- Proponents of this view think the preferred shareholders have a right to Company B's profits through distributions and exposure to changes in fair value of the investee's assets through liquidation rights. In addition, in a liquidation event that results in net liabilities, preferred shareholders are exposed to negative changes in fair value of Company B's net assets.
- Furthermore, proponents of this view considered the common shares that can be converted from preferred shares at the option of the holder. They note these common shares can give Company A additional voting power and can create exposure to Company B's profit and losses. Furthermore, the lack of protection in the event of liquidation exposes Company A to a potential loss of investment in Company B.
- As such, Company A's exposure to Company B's profit, losses, and fluctuations in fair value of net assets provides, in combination with other rights, present ownership interest in Company B. Therefore, proponents of this view think these preferred shares should be included when calculating Company A's share of investment income or loss in Company B.

The Group's Discussion

Group members supported View 2A. They noted that the preferred shares do not represent existing ownership rights when considering features such as non-voting, liquidation preference over common shareholders, and the required dividend payments based on a coupon rate. One Group member also noted that the preferred shares do not give Company A rights to Company B’s profits given the fact pattern only states the dividends are based on a set coupon rate, but does not specify that they must be paid from Company B’s profit.

Overall, the Group’s discussion raises awareness about whether preferred shares represent existing ownership rights to be considered when calculating the investor’s share in investee’s income or loss under the equity method of accounting. Some Group members observed that the diverse views on Issue 1 can be attributed to a lack of guidance in IAS 28 on what constitutes a present ownership interest. They thought this could be raised as a topic in the IASB’s agenda consultation. The AcSB Chair commented the Board is aware of the issues associated with applying the equity method of accounting in IAS 28. The Board will consider the Group’s discussion when drafting its response to the IASB’s agenda consultation request. No further action was recommended to the Board.