STAFF PAPER

January 2014

IFRS Interpretations Committee Meeting

Project	**Amendments to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investment in Associates and Joint ventures***
Paper topic	Inconsistency with paragraph 31 of IAS 28

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Introduction

1. This paper describes a new issue that was identified by the IFRS Interpretations Committee ('the Interpretations Committee') during its work on the Exposure Draft *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (proposed amendments to IFRS 10 and IAS 28), which had been published for comment in December 2012.
2. In July 2013, the Interpretations Committee recommended that the IASB should proceed with the amendments to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures* (issued in 2011). In October 2013, the IASB tentatively decided to finalise the proposed amendments to IFRS 10 and IAS 28 (2011).
3. In July 2013, the Interpretations Committee decided that further analysis and discussion are needed before proposing whether or not the IASB should amend or delete paragraph 31 of IAS 28, which is perceived as conflicting with the proposed amendments to IFRS 10 and IAS 28 (2011). This additional issue was raised by some respondents to the proposed amendments. The Interpretations Committee asked the staff to bring a paper to a future meeting regarding this issue.

Objective

4. The objective of this paper is to:
   (a) provide background information on this issue;
   (b) provide an analysis of the issue, including a summary of the outreach responses received;
   (c) present an assessment of the issue against the Interpretations Committee's agenda criteria;
   (d) make a recommendation to the Interpretations Committee; and
   (e) ask the Interpretations Committee whether it agrees with the staff's recommendation.

Background information

5. Paragraph 31 of IAS 28 (2011) states that:

> 31 If, in addition to receiving an equity interest in an associate or a joint venture, an entity receives monetary or non-monetary assets, the entity recognises in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received.

6. Paragraph BCZ36 explains that:

> BCZ36 To the extent that the entity also receives monetary or non-monetary assets dissimilar to the assets contributed in addition to equity interests in the investee, the realisation of which is not dependent on the future cash flows of the investee, the earnings process is complete. Accordingly, an entity should recognise in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received.

7. In October 2013, the IASB tentatively decided to amend IAS 28 (2011) so that:

   (a) when an entity sells or contributes assets that constitute a business to a joint venture or associate, the gain or loss recognised by the entity is recognised in full; whereas

   (b) when an entity sells or contributes assets that do not constitute a business to a joint venture or associate, the gain or loss recognised by the entity is limited to the unrelated investors' interests in the associate or joint venture.

8. The draft wording of the forthcoming amendments to IAS 28 will not change the requirements of paragraph 31 of IAS 28.

9. The IASB plans to issue the final amendments to IFRS 10 and IAS 28 in the first quarter of 2014.

Staff analysis

The issue

10. Some respondents to the Exposure Draft *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* think that paragraph 31 of IAS 28 is not consistent with the proposed amendments to IAS 28. They think that the IASB should amend paragraph 31 of IAS 28 and should require partial gain or loss recognition for all sales and contributions of assets that do not constitute a business (whether those assets are monetary or non-monetary assets and whether the contribution is made in exchange for an equity interest in the investee or in exchange for other assets). In particular, they do not think that the nature of the assets received from the associate or joint venture should warrant a different accounting.

Staff view

11. We think that paragraph 31 is not consistent with the forthcoming amendments to IAS 28 and anomalous with the existing requirements, because:

    (a) the outcome of paragraph 31 of IAS 28 is that the accounting for the gain or loss resulting from the contribution of non-monetary assets depends on whether an equity interest or other assets are received in exchange (ie a full gain is recognised on the contribution relating to the other assets received and a partial gain is recognised on the contribution relating to the equity interest received); whereas

(b) the IASB and the Interpretations Committee tentatively decided that all sales and contributions of assets (that do not constitute a business) between an investor and its associate or joint venture should be accounted for consistently, ie a partial gain should be recognised in those cases (except when the contribution lack commercial substance).

12. In addition, if there is no equity interest received, then only a partial gain is recognised in respect of the consideration received, whereas if there is even just a small equity consideration received, then a full gain is recognised in respect of the non-equity consideration received.

13. We think that there is also a different rationale behind paragraph 31 of IAS 28 compared with the other requirements of IAS 28 regarding transactions with associates and joint ventures. Indeed, paragraph BCZ36 refers to the earnings process being complete. It interprets the completion of the earnings process as being complete when monetary or non-monetary assets are received from the associate and suggests that because the economic benefits associated with those monetary and non-monetary assets are not dependent on the future cash flows of the associate, then the earnings process is complete on receipt of those assets. However, in our view, this is contrary to the existing guidance in IAS 28, which requires full gain recognition only when the economic benefits of the asset transferred to the associate (or joint venture) is consumed/realised by the associate or joint venture[1].

14. In other words, the existing requirements of IAS 28 for all other transactions with the associate or joint venture are independent of the nature of the assets received. The proposed amendments that were tentatively agreed by the IASB in October 2013 are also independent of the nature of the assets received. They focus instead on the nature of the assets contributed.

15. We also think that:

(a) the accounting for a contribution should not depend on whether cash, other assets or an equity interest are received in exchange for that contribution;

[1] Paragraph 26 of IAS 28 states that: “Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10…”

(b) recognising a full gain as required by paragraph 31 creates structuring opportunities. For example:

  (i) an investor would recognise a partial gain on the sale of assets (that do not constitute a business) to an associate or joint venture (in exchange for cash); whereas

  (ii) another investor would recognise a full gain on the contribution of assets (that do not constitute a business) for the portion relating to cash received, if cash is received in addition to receiving an equity interest in the associate or joint venture.

16. In July 2013 we recommended deleting paragraph 31 of IAS 28, on the basis of the analysis above.

Outreach requests

17. We asked IOSCO, ESMA and national standard-setters the following two questions:

  (a) How common are the transactions in scope of paragraph 31 of IAS 28?

  (b) Do you envisage any unintended consequences that could arise from the deletion of paragraph 31 of IAS 28?

18. We received responses from IOSCO and the following 12 jurisdictions: Europe (3), Asia (4), Americas (3), Oceania (1) and Africa (1).

19. The transactions within the scope of paragraph 31 of IAS 28 are common only in three jurisdictions.

20. Nine respondents did not envisage any unintended consequences that could arise from the deletion of paragraph 31 of IAS 28.

21. We understand that many respondents think that paragraph 31 is not consistent with the forthcoming amendments to IAS 28.

22. We report below the main comments received on the question regarding the unintended consequences that could arise from the proposed deletion of paragraph 31 of IAS 28.

23. One respondent states that:

> We wonder whether the proposed treatment is not detrimental to the requirements for transitioning from IAS 31 to IFRS 11 in cases where an entity had previously proportionately consolidated its joint ventures and would now be required to equity account for them. In cases where initial application of IFRS 11 would lead to a negative net asset value, the entity shall determine whether it has a constructive obligation (IFRS 11.C4). If so, the entity would recognize the negative amount as a liability; if not, it would adjust the opening balance of retained earnings and disclose the effect. Conceptually speaking, the negative net asset amount determined under IFRS 11.C2 might stem from the same fact of having to eliminate gains or losses, which upon consolidation would lead to recognition of a credit in the statement of financial position. We suggest the Staff evaluates and explains the rationale for the difference in treatments under the transition requirements for IFRS 11 – recognition of any difference in equity – and the proposal for IAS 28 – recognition of a deferred gain.

24. Another respondent states that:

> We received mixed views as to whether there are any unintended consequences that could arise from the deletion of paragraph 31 of IAS 28.
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> A number of them were of the view that paragraph 31 is helpful in clarifying the accounting for such transaction and its deletion might lead to diversity in practice i.e. gain or loss on the contribution relating to the monetary or non-monetary assets received might be recognised in full in some circumstances and recognised only to the extent of the unrelated investors' interests attributable to the monetary or non-monetary assets received in other circumstances. They noted paragraph BZ36 of IAS 28 (2011) states that, to the extent that an entity also receives monetary or non-monetary assets dissimilar to the assets contributed in addition to equity interests in the investee, an entity should recognise in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received because the earnings process is complete and its realisation is not dependent on the future cash flows of the investee. Accordingly, these respondents suggested that paragraph BZ36 of IAS 28 (2011) should instead be emphasized.

> However, there was also others who believed that the existing paragraph 31 creates confusion as it is contracting with the proposed amendments to IFRS 10 and IAS 28. Therefore, the deletion of paragraph 31 would conform to the proposed amendments in recognising full gain/loss for sales or contributions of assets that constitute a business and a partial gain/loss recognition for sales or contributions of assets that do not.

25. Another respondent states that:

> Another constituent indicated that there are structuring opportunities as a result of this allowance that will impact the timing of the recognition of revenue. However, they don't believe it will be correct to delete paragraph 31 as it is in accordance with any other difference between accounting for a business controlled (subsidiary) and one not controlled (associate and joint venture). As soon as control is lost over a subsidiary (even if no shareholding changed) this could also trigger a large profit on disposal and the recognition of an associate at fair value.
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> One constituent pointed out that they understand that the amendment, if approved, would be presented with the other amendments to IAS 28 that would require and entity to always eliminate some portion of a gain for a transaction taking place between an investor and an associate, even if the carrying amount of the associate is smaller than the amount of the portion of the gain to be eliminated. Therefore, the amount that cannot be eliminated against the carrying amount of the associate would be recognised as a deferred gain. They are unsure whether this is an intended consequence of the amendment.

26. On the basis of the comments received, we think that the transactions within the scope of paragraph 31 of IAS 28 are not common and that the deletion of this paragraph would not have significant unintended consequences.

Agenda criteria assessment

27. Our assessment of the Interpretations Committee's agenda criteria is as follows:

Source of issue
Issues could include: the identification of divergent practices that have emerged for accounting for particular transactions, cases of doubt about the appropriate accounting treatment for a particular circumstance or concerns expressed by investors about poorly specified disclosure requirements (5.14).

Criteria	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected; where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	No. On the basis of our outreach, the transactions within the scope of paragraph 31 of IAS 28 are not common.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (5.17)?	Not applicable
Will it be effective for a reasonable time period (5.21)? Only take on the topic of a forthcoming Standard if short-term improvements are justified.	Not applicable

Staff recommendation

28. We think that paragraph 31 of IAS 28 is not consistent with the forthcoming amendments to (and the existing requirements of) IAS 28.

29. On the basis of our assessment against the Interpretations Committee's agenda criteria, we think that the Interpretations Committee should not add this issue to its agenda as a separate issue, because the transactions within the scope of paragraph 31 of IAS 28 are not common.

30. However, we recommend that the Interpretations Committee should propose to the IASB to include this issue in the proposed narrow-scope amendments to IAS 28 *Elimination of gains arising from 'downstream' transactions*[2], because on the basis of our analysis there is an inconsistency within IAS 28 and we do not expect significant unintended consequences from the deletion of paragraph 31 of IAS 28.

[2] The Exposure Draft is expected to be published in Q1 2014

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree that paragraph 31 of IAS 28 is not consistent with the forthcoming amendments to (and the existing requirements of) IAS 28?

2. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should recommend the IASB to include this issue in the proposed narrow-scope amendments to IAS 28 *Elimination of gains arising from 'downstream' transactions*?