IFRS Accounting

Staff paper

Agenda reference: 13A

IASB® meeting

Date	**January 2023**
Project	**Equity Method**
Topic	**Perceived conflict between IFRS 10 and IAS 28–further considerations of applying the four alternatives**
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Introduction

1. At its September 2022 meeting, the International Accounting Standards Board (IASB) started to discuss a new set of application questions related to 'Transactions between an investor and its associate', in particular the application question:[1]

> How should an investor recognise gains and losses that arise from the sale of a subsidiary to its associate, applying the requirements in IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*?

2. At that meeting, the IASB discussed four alternatives identified by the staff (reproduced in paragraph 9 of this paper) to address the application question in paragraph 1 of this paper. The IASB was not asked to make any decisions.

Objective of this agenda paper

3. The objective of this paper is to:

   (a) continue deliberating the four alternatives to answering the application question in paragraph 1 of this paper; and

   (b) discuss further considerations on applying the four alternatives, in particular whether:

      (i) 'upstream' and 'downstream' transactions should be affected in the same way when applying any of the alternatives; and

      (ii) the disclosure requirements in IAS 24 *Related Party Disclosures* provide users with sufficient useful information about the gain or loss arising from transactions in the application question, particularly if Alternative 1 is pursued.

4. The IASB is not asked to make decisions at this meeting, see the next steps set out in paragraphs 49–50 of this paper.

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[1] See September 2022 IASB meeting; AP13C: Transactions between an investor and its associate–An acknowledged inconsistency between the requirements of IFRS 10 and IAS 28.

Structure of this paper

5. The paper is structured as follows:

   (a) summary of the application question (paragraphs 6–8 of this paper);

   (b) summary of the four alternatives discussed at the September 2022 IASB meeting (paragraphs 9–13 of this paper);

   (c) further considerations of applying the four alternatives:

      (i) ‘upstream’ transactions (paragraphs 14–36 of this paper); and

      (ii) disclosure requirements in IAS 24 (paragraphs 37–48 of this paper);

   (d) next steps (paragraphs 49–50 of this paper); and

   (e) questions to IASB members.

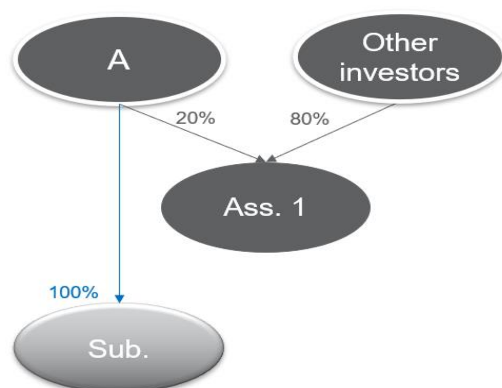
Summary of the application question

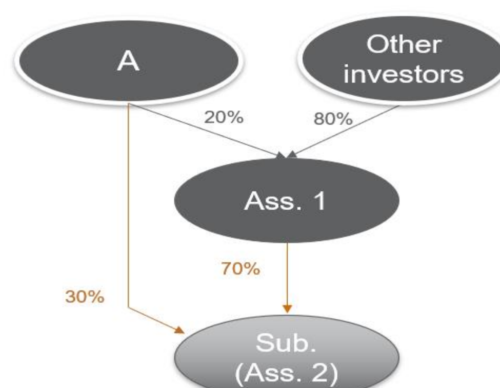
6. As noted in paragraph 1 of this paper, there is a perceived conflict between the requirements of IFRS 10 and IAS 28 when an investor sells a subsidiary to its associate. The perceived conflict arises because:

   (a) paragraphs 25 and B97–B99 of IFRS 10 require an investor to recognise in full the gain or loss on the loss of control of a subsidiary, remeasuring any retained interest at fair value; whereas

   (b) paragraphs 28 and 30 of IAS 28 require an investor to restrict the gain or loss recognised to the extent of the unrelated investors’ interests in an associate, that is an investor reduces the gain for its related interest (elimination entries).

7. The following diagram illustrates a sale of a subsidiary from an investor (retaining an interest in the former subsidiary) to its associate, before and after the transaction.





8. For further details on the history of this perceived conflict, including the amendment issued in 2014 (2014 Amendment) with the effective date deferred indefinitely, refer to Appendix A to Agenda Paper 13C of the September 2022 IASB meeting.

Summary of the four alternatives discussed at the September 2022 IASB meeting

9. The following table summarises the four alternatives discussed by the IASB at its September 2022 meeting to address the application question. Paragraphs 33–69 of Agenda Paper 13C of the September 2022 IASB meeting discussed further the rationale behind each alternative and provided:

   (a) the staff's preliminary analysis;

   (b) which IFRS Accounting Standards would need to be amended; and

   (c) advantages and disadvantages of those four alternatives.

Recognition of **full** gain or loss *versus* **partial** gain or loss	**Sale/contribution of a *business* that is**		**Sale/contribution of an *asset* that is**	
	***housed* in a subsidiary**	***not housed* in a subsidiary**	***housed* in a subsidiary**	***not housed* in a subsidiary**
Alternative 1 *(No elimination)*	Full	Full	Full	Full
Alternative 2 *(Elimination)*	Partial	Partial	Partial	Partial
Alternative 3 *(Mixture)*	It depends on whether a transaction is[2]			
	NOT an output of investor's ordinary activities[3]		an output of investor's ordinary activities	
	Full		Partial	
Alternative 4 *(Reviving 2014 Amendment)*	Full	Full	Partial	Partial
Current practice approach(es)	Policy choice (full/partial)[4]	Unclear[5]	Many towards policy choice (full/partial)[6]	Partial

[2] In other words, whether a transaction is in the scope of IFRS 15 *Revenue from Contracts with Customers* or not.
[3] Paragraphs BC52–BC53 of the Basis for Conclusions on IFRS 15 explains that the IASB decided to define the term 'customer' to enable an entity to distinguish contracts that should be accounted for under IFRS 15 (ie contracts with customers) from contracts that should be accounted for under other requirements. The definition of a 'customer' focuses on an entity's ordinary activities.
[4] Most audit practice manuals state that an entity has an accounting policy choice of applying consistently either IFRS 10 or IAS 28. Some audit practice manuals do not make distinction whether subsidiary constitutes a business or not.
[5] Many audit practice manuals do not have specific guidance, while some allowed full gain or loss (ie applying the 2014 Amendment).
[6] Many audit practice manuals provide an accounting policy choice, while some does not have specific guidance.

Alternative 1—applying IFRS 10 to all contributions and sales

10. Alternative 1 would require an investor to recognise the full gain or loss on all contributions and sales of assets or businesses, regardless of whether they are housed or not in a subsidiary—under this alternative, no elimination entries' requirements apply.

Alternative 2—apply IFRS 10 and then IAS 28 to all contributions and sales

11. Alternative 2 would require an investor to recognise a partial gain or loss on all contributions and sales of assets or businesses, regardless of whether they are housed or not in a subsidiary—under this alternative, the requirements of IFRS 10 and IAS 28 are both applied to the transaction.

Alternative 3—apply IFRS 10 depending on whether contributions and sales are an output of ordinary activities or not

12. Alternative 3 would require an investor to recognise:

    (a) a partial gain or loss on transactions in the scope of IFRS 15 *Revenue from Contracts with Customers*; and

    (b) the full gain or loss on transactions outside the scope of IFRS 15.

Alternative 4—apply IFRS 10 for contributions and sales of businesses and IAS 28 for sales of assets

13. Alternative 4 would revive the 2014 Amendment and would require an investor to recognise:

    (a) the full gain when a transaction involves a business; and

    (b) a partial gain when a transaction involves an asset.

Further considerations of applying the four alternatives—'Upstream' transactions

Background

14. As noted in paragraphs A1–A2 of Appendix A to Agenda Paper 13C of the September 2022 IASB meeting:

    (a) 'downstream' transactions are, for example, sales or contributions of assets from the investor (or a subsidiary in the same group as the investor) to its associate.

    (b) 'upstream' transactions are, for example, sales of assets from an associate to the investor (or a subsidiary in the same group as the investor).

15. Paragraph 28 of IAS 28 requires gains and losses from 'upstream' and 'downstream' transactions between an investor and its associate to be recognised in the investor's financial statements to the extent of the unrelated investors' interests in the associate. In other words, the elimination entries' requirements affect both 'upstream' and 'downstream' transactions.

16. It should be noted that the application question in paragraph 1 of this paper initially asked only about 'downstream' transactions.

17. The questions we need to answer are:

    (a) whether 'upstream' and 'downstream' transactions should be affected in the same way when applying any of the alternatives discussed by the IASB at its September 2022 meeting; and

    (b) if (a) is yes, what are the potential implications of applying the alternatives to 'upstream' transactions.

Staff analysis

Should 'upstream' and 'downstream' transactions be affected in the same way?

18. Some argue that, as the objective of elimination entries when applying the equity method is unclear (see paragraphs 18–19 and 26 to Agenda Paper 13C of the September 2022 IASB meeting) there is no clear rationale that 'upstream' and 'downstream' transactions should be affected in the same way. This is because:

    (a) in an upstream transaction, a degree of 'control' over an asset exists (eg sale of an asset from an associate to the investor) and, therefore, the elimination entries could be justified; whereas

    (b) in a downstream transaction, 'control' over an asset is replaced with 'significant influence' over the investment itself (eg sale or contribution an asset from the investor to its associate) and, therefore:

        (i) in applying the reporting entity concept in accordance with the *Conceptual Framework,* the absence of control puts more pressure on the objective of the elimination entries in IAS 28; but

        (ii) if parent-entity perspective had been relevant, an investor would restrict the gain because the investor is trying to measure the gain that a particular group of shareholders would have earned.

19. However, others do not agree with distinguishing between 'upstream' and 'downstream' transactions and argue that this would introduce new complexities and judgements into the application of the equity method.

20. Whilst the staff acknowledge there could be a technical merit in investigating the objective of elimination entries when applying the equity method and the different perspectives noted in paragraph 18 of this paper, it is likely addressing this topic would require assessing the conceptual nature of the equity method and therefore would be outside the scope of this project.

21. Therefore, the staff is of the view that both 'upstream' and 'downstream' transactions should be affected in the same way in applying each of the four alternatives discussed by the IASB at its September 2022 meeting.

US GAAP

22. The staff note that the US GAAP treats 'upstream' and 'downstream' transaction differently, depending on the transaction. The following table summarises the US GAAP requirements.

<table>
<tr><th>Derecognition guidance</th><th>Example transaction between an investor and its associate</th><th>Downstream</th><th>Upstream</th></tr>
<tr><td>ASC 606 Revenue from Contracts with Customers</td><td>Sale of inventory that is an output of an entity's ordinary activities</td><td colspan="2">Eliminate proportionate share of profit if the asset remains on the books of the recipient at the end of the reporting period.</td></tr>
<tr><td>ASC 810 Consolidation (ASC 810-10-40-3A through 40-5)</td><td>Sale of a business</td><td>No profit elimination (ASC 323 Investments-Equity Method and Joint Ventures—ASC 323-10-35-7(a)).</td><td>Eliminate proportionate share of profit if the business remains on the books of the recipient at the end of the reporting period.</td></tr>
<tr><td>ASC 610 Other Income (ASC 610-20)</td><td>Sale of equipment that is not an output of an entity's ordinary activities</td><td>No profit elimination (ASC 323-10-35-7(c)).</td><td>Eliminate proportionate share of profit if the asset remains on the books of the recipient at the end of the reporting period.</td></tr>
</table>

What are the potential implications of applying the alternatives to 'upstream' transactions?

23. Following to the staff's view in paragraph 21 of this paper, paragraphs 26 to 36 of this paper discuss the potential implications to 'upstream' transactions for each of the alternatives.

24. The staff will discuss at a future IASB meeting the application question: *in an upstream transaction, whether an investor eliminates its share of gain or loss from the carrying amount of the investment in the associate or the acquired asset.*

25. The staff note the possible solutions to the application question in paragraph 24 of this paper could affect how each of the alternatives applies to 'upstream' transactions, particularly if, in addressing that application question, the IASB were to decide to require an investor to eliminate its share of the gain or loss from the acquired asset.

Alternative 1

26. Applying Alternative 1 would not require elimination entries for 'upstream' transactions irrespective of whether involving:

    (a) a subsidiary or assets that constitute(s) a business; or

    (b) an asset that is housed in a subsidiary.

27. Therefore, an investor would apply:

    (a) IFRS 3 *Business Combinations* if it is a business acquisition. In that case, an investor would:

        (i) recognise the assets and liabilities acquired at their fair values; and

        (ii) recognise its share in the associate's gains or losses resulting from the disposal of the business (as part of 'post-acquisition changes' procedure in accordance with IAS 28).

(b) IAS 16 *Property, Plant and Equipment* if it is an asset acquisition. In that case, an investor would:

  (i) recognise the asset acquired at its cost (which is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset); and

  (ii) recognise its share in the associate's gains or losses resulting from the disposal of the asset (as part of 'post-acquisition changes' procedure in accordance with IAS 28).

Alternative 2

28. Applying Alternative 2 an investor would apply the requirements of IFRS 3 (or IAS 16) and IAS 28 to the transaction.

29. Therefore, an investor would apply:

  (a) IFRS 3 if it is a business acquisition. In this situation, an investor would:

    (i) recognise the assets and liabilities acquired at their fair values;

    (ii) recognise its share in the associate's gains or losses resulting from the disposal of the business (as part of 'post-acquisition changes' procedure in accordance with IAS 28); and

    (iii) overlay with the elimination entries' requirements in IAS 28 by restricting the gain or loss recognised in (ii), which effectively means eliminating in full the investor's share in the associate's gains or losses resulting from the disposal of that business (see paragraph 30 of this paper for further considerations).

  (b) IAS 16 if it is an asset acquisition. In this situation, an investor would:

    (i) recognise the asset acquired at its cost (which is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset);

    (ii) recognise its share in the associate's gains or losses resulting from the disposal of the asset (as part of 'post-acquisition changes' procedure in accordance with IAS 28); and

    (iii) overlay with the elimination entries' requirements in IAS 28 by restricting the gain or loss recognised in (ii), which effectively means eliminating in full the investor's share in the associate's gains or losses resulting from the disposal of that asset (see paragraph 31 of this paper for further considerations).

30. As noted in paragraph 25 of this paper, if in addressing the application question in paragraph 24 of this paper, the IASB were to decide to propose an investor eliminates its share of the gain or loss from the acquired asset, the staff think this could lead to potential complications in applying the elimination entries' requirements set out in paragraph 29(a)(iii). This is because a question would arise on how to allocate (or proportion) the eliminated amount of the gain or loss on the assets and liabilities acquired in a business combination.

31. For paragraph 29(b)(iii) of this paper, the staff note that this would be consistent with the requirements in paragraphs 28 and 30 of IAS 28.

Alternative 3

32. For the downstream transactions, an investor would recognise:

    (a) the full gain on transactions outside the scope of IFRS 15; and

    (b) a partial gain on transactions in the scope of IFRS 15 (even if housed in a subsidiary).

33. Therefore, the staff think that when applying Alternative 3 to upstream transactions, an investor would apply:

    (a) paragraph 27 of this paper for transactions outside the scope of IFRS 15.

    (b) paragraph 29 of this paper for transactions in the scope of IFRS 15.

34. However, a question that will need to be answered is: should the assessment of whether an upstream transaction is in the scope of IFRS 15 be performed from the investor's or its associate's perspective. The staff think that such an assessment should be performed from the investor's perspective considering the 'purpose of purchase' because:

    (a) IAS 28 addresses the accounting for investments in associates from the point of view of the investor's financial statements; and

    (b) the merit of Alternative 3 is to preserve eliminations to the extent that the transactions between an investor and its associate affect the investor's performance in relation to its operating activities.

Alternative 4

35. Applying Alternative 4 an investor would apply IAS 28:

    (a) to 'upstream' transactions involving a subsidiary or assets that do not constitute a business; but

    (b) not apply IAS 28 to 'upstream' transactions involving a subsidiary or assets that constitute(s) a business.

36. The staff, therefore, think that an investor would account for this transaction at the same way as set out in:

    (a) paragraph 27(a) of this paper if it is a business acquisition.

    (b) paragraph 29(b) of this paper if it is an asset acquisition.

Further considerations of applying the four alternatives—Disclosure requirements in IAS 24

Background

37. Paragraph 18 of IAS 24 states that:

> If an entity has had related party transactions during the periods covered by the financial statements, it shall disclose the nature of the related party relationship as well as ***information*** about those transactions and outstanding balances, including commitments, necessary for users to understand the potential effect of the relationship on the financial statements… At a ***minimum***, disclosures shall include:
>
> ***(a) the amount of the transactions***;
>
> (b) the amount of outstanding balances, including commitments, and:
>
> > (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
> >
> > (ii) details of any guarantees given or received;
>
> (c) provisions for doubtful debts related to the amount of outstanding balances; and
>
> (d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.

38. Paragraph 19 of IAS 24 states that:

> The disclosures required by paragraph 18 shall be made separately for each of the following categories:
>
> (a) the parent;
>
> (b) entities with joint control of, or significant influence over, the entity;
>
> (c) subsidiaries;
>
> (d) ***associates***;
>
> (e) joint ventures in which the entity is a joint venturer;
>
> (f) key management personnel of the entity or its parent; and
>
> (g) other related parties.

39. In September 2004, the IFRS Interpretations Committee (Committee) issued an agenda decision on *'IAS 24: Interpretation of the term "information" in IAS 24 paragraph 18'.* The Committee was asked to supplement the minimum disclosures in paragraph 18 regarding 'transactions and outstanding balances necessary for an understanding of the potential effect of (related party) relationships on the financial statements'. For example, it was suggested that an interpretation of paragraph 18 should specifically require disclosure of the purpose and economic substance of transactions, identity of related parties, extent of management involvement, special risks and the effect of such transactions on the financial statements.

40. The Committee decided not to add this issue to its agenda, noting that the IASB, in its revisions to IAS 24 in 2003, debated the extent of specific minimum disclosure requirements and the suggested items were not included. The Committee decided that, because of wider policy considerations, this issue might be appropriate for discussion by the IASB and, perhaps, the Standards Advisory Council.

41. The question we need to answer is: whether disclosure requirements in IAS 24 provide users with sufficient information about the gain or loss arising from transactions between an investor and its associate.

Staff analysis

42. The staff note that Alternative 2, Alternative 3 or Alternative 4 do not introduce any new requirements, but instead clarify in which situations:

    (a) the requirements in IFRS 10 are applied;

    (b) the requirements in IAS 28 are applied; or

    (c) both the requirements in IFRS 10 and IAS 28 are applied.

43. The staff also note that in applying the disclosure requirements set out in paragraphs B12–B14 of IFRS 12 *Disclosure of Interests in Other Entities* (that is an investor shall disclose summarised financial information for its associate) and in reconciling the summarised financial information to the carrying amount of the investor's interest in an associate, impliedly, disclosure of any elimination of gains or losses on downstream or upstream transactions is required. In other words, the IFRS 12 requirements would, impliedly, require disclosing the effect of eliminations. The staff, therefore, do not think that additional disclosures, as a consequence of applying those alternatives, are required or needed.

44. However, if Alternative 1 is taken forward, which does not require elimination entries, then there might be merit in enhancing some of the disclosure requirements in IAS 24 to help users to understand the effect on the financial statements of 'upstream' and 'downstream' transactions.

45. Some argue that disclosure requirements in paragraph 18 of IAS 24 provide an adequate disclosure objective and assist entities exercise judgment in disclosing the information necessary for users understand the effect on the financial statements of 'upstream' and 'downstream' transactions.

46. However, others do not agree, given the Committee's discussion set out in paragraphs 39–40 of this paper, and argue that not requiring elimination entries would be a substantial change to the requirements in IAS 28. Those that hold this view often believe that the equity method is a one-line consolidation method. They argue if Alternative 1 is taken forward consequential amendments are required to enhance the disclosure requirements in IAS 24 to mitigate their concerns.

47. A possible proposal could be to supplement the minimum disclosures in paragraph 18 of IAS 24 to require an investor to also disclose the amount of the gain or loss arising from transactions between an investor and its associate (not only the amount of the transactions).

48. The staff think that, if Alternative 1 is taken forward, to provide users with more useful information, an investor should be required to disclose the amount of the gain or loss arising from transactions between an investor and its associate.

Next steps

49. The staff will use the feedback from this IASB meeting, on Agenda Papers 13A–13B of this meeting, to refine the analysis and develop recommendations for decision-making at a future meeting.

50. Once the IASB has made a tentative decision on the application question sets out in paragraph 1 of this paper, the staff will start, if there is still a need, exploring answers for the other application questions, related to: *Transactions between an investor and its associate*, set out in paragraphs 1(b)–(d) to Agenda Paper 13C of the September 2022 IASB meeting.

Questions to IASB members
1. Do you have comments or questions on the information included (including the staff analysis performed) in Agenda Papers 13A–13B of this meeting? 2. Do you require any further information in advance of the staff bringing to the IASB a decision-making paper?