IFRS Accounting

Staff paper

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IASB® meeting

Date	**March 2023**
Project	**Equity Method**
Topic	**Perceived conflict between IFRS 10 and IAS 28–feedback summary on the outreach activities undertaken with users**
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Introduction

1. At its September 2022 meeting, the International Accounting Standards Board (IASB) started to discuss application questions related to 'Transactions between an investor and its associate', in particular it discussed four alternatives to answering the application question: *How should an investor recognise gains or 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?[1]

2. At its January 2023 meeting, the IASB continued discussing:

   (a) the four alternatives; and

   (b) feedback from; the accounting firms, Accounting Standards Advisory Forum (ASAF) and Global Preparers Forum (GPF).[2]

3. At that meeting, the IASB asked the staff to:

   (a) continue exploring two of four alternatives discussed in its September 2022 meeting to answering the application question;

   (b) undertake outreach with users of financial statements (users); and

   (c) prepare a decision-making paper.

[1] See September 2022 IASB meeting; AP13C.

[2] See January 2023 IASB meeting; AP13A and AP13B.

4. In this paper, the term(s):

   (a) 'investor' refers to an entity which has significant influence over another entity 'an associate' but not control;

   (b) 'unrelated investors' interests in the associate' refers to the interest of investors other than the investor; and

   (c) 'elimination entries' requirement' or 'restricting gains or losses' refers to the requirement in paragraph 28 of IAS 28, which requires an investor to restrict the gains or losses from transactions between an investor and its associate to the extent of the unrelated investors' interests in an associate.

Purpose of this paper

5. The purpose of this paper is to summarise feedback from the outreach with users on:

   (a) whether restricting gains or losses on transactions between an investor and its associate affect the quality of earnings reported when applying the equity method of accounting;

   (b) and if so, how:

      (i) it affects users' decision-making; and

      (ii) whether it would be useful if an investor disclosed the gains or losses on transactions between itself and its associate; and

   (c) which of the alternatives provides users with the most useful information.

6. This paper does not include questions for the IASB. IASB members may wish to refer to the contents of this paper when discussing Agenda Paper 13B of this meeting.

Structure of this paper

7. The paper is structured as follows:

   (a) scope of the outreach (paragraphs 8–10 of this paper);

   (b) key messages (paragraphs 11–14 of this paper); and

   (c) summary of feedback (paragraphs 15–22 of this paper).

Scope of the outreach

8. The staff undertook three outreach meetings with user advisory committees from jurisdictions/regions:

   (a) two from 'Asia-Oceania' region.

   (b) one from 'The Americas' region.

9. The staff will also verbally summarise the feedback received from Capital Markets Advisory Committee (CMAC) meeting on 9 March 2023 to the IASB's members during this IASB meeting.

10. To facilitate productive discussions, the staff have provided participants (using the same supporting material presented to the CMAC meeting on 9 March 2023) with illustrative examples, which include the extracts from the financial statements and notes. To demonstrate how restricting gains or losses affect the investors' financial statements two examples are provided:

    (a) a downstream example, with and without restricting gains or losses.

    (b) an upstream example, with and without restricting gains or losses.

Key messages

11. In evaluating the financial statements of an investor with investments that are equity-accounted associates, users have different priorities depending on the materiality of the associate:

    (a) if the associate is material, they will evaluate the associate separately. Valuation will be based on the associate's financial statements, if available, which do not restrict gains or losses for transactions between an investor and its associate; whereas

    (b) if the associate is not material, they will rely on the associate's earnings as reported in the investor's financial statements. These earnings will, when applicable, restrict gains or losses for transactions between an investor and its associate.

12. In considering the equity method earnings to assess earnings quality of the associate, users want to assess the 'gains or losses' arising from these transactions. Users noted the lack of sufficient disaggregation of earnings in the investor's financial statements often restricts their ability to assess earnings quality.

13. Restricting (or not restricting) gains or losses does not affect net cash flows from these transactions but changes the pattern of earnings. Restricting gains or losses, leads to non-cash profits/losses, which might not be necessarily relevant to users in modelling future cash flows.

14. Users support enhancing the disclosure requirements to require an investor to disclose the amount of the gains or losses from these transactions. Enhancing this disclosure requirement:

    (a) would allow users to adjust for the restricted gain or loss to fit it for their analysis.

    (b) to 'toggle' between elimination and no elimination methods.

Summary of feedback

15. Users said that, when evaluating the financial statements of an investor with investments that are equity-accounted associates, they have different priorities depending on the materiality of the associate. Materiality is assessed on whether the associate contributes significantly to investor's earnings/income.

16. Users said:

    (a) if the associate is material, they will evaluate the associate separately (that is, they will review the associate's main business activities independently from the investor's main business). In analysing financial performance, users will prioritise the associate's earnings as reported in its financial statements. Valuation will be based on these financial statements which do not restrict gains or losses for transactions between an investor and its associate;[3] whereas

    (b) if the associate is not material, they will rely on the associate's earnings as reported in the investor's financial statements. These earnings will, when applicable, restrict gains or losses for transactions between an investor and its associate.

17. Users noted that in practice:

    (a) most associates are unlisted entities and may be located in overseas jurisdictions. Consequently, it is not always easy to obtain the associate's financial statements, leaving them to rely only on the amounts reported in the investor's financial statements.

    (b) the information disclosed for associates in the investor's financial statements is limited, that is, it does not provide sufficient disaggregation of earnings to understand the effect of associates on the investors' earnings.

18. Users supported requiring disclosure of the amount of the gains or losses, at the transaction date, arising from transactions between an investor and its associate (in addition to the amount of the transactions) for the following reasons:

    (a) it complements the disclosure requirements in IAS 24 *Related Party Disclosures*, allowing users the flexibility to value gains or losses in analysing the associate's performance;

    (b) it helps to understand the reasonableness, fairness and sustainability of these transactions (and their pricing) and benchmark against market terms;

[3] In doing so, some users would additionally consider information included in the associate's Management Commentary (ie management discussion and analysis 'MD&A').

(c) it helps to understand whether there is a conflict of interest, that is whether these transactions really are arm's length transactions; and

(d) it reduces the burden on preparers that have difficulty obtaining information from associates.

19. There was mixed feedback from users on whether Alternative 1 (No elimination) or Alternative 2 (Elimination) would provide them with the most useful information:

(a) some expressed a preference for Alternative 1, because:

(i) an investor does not have control over the associate, therefore, an investor earnings should not be affected (that is, the investor and its associates are not a single economic entity and, therefore, such transactions are similar to transactions with a third party);

(ii) it is easier to understand and analyse the associate's financial information when relying on the associate's earnings as reported in the investor's financial statements; and

(iii) it is better to disclose the gains or losses enabling them to decide how and whether to include these gains or losses in their valuation models.

(b) some users did not express a preference for either Alternative 1 or Alternative 2 but said that restricting (or not restricting) gains or losses does not affect cash flows from these transactions but changes the pattern of earnings. They also noted, the effect of these transactions is relatively small in the context of many transactions, and obtaining more information about related party transactions would allow them to adjust the gains or losses based on their own judgement. Finally, they noted that, Alternative 1 is the most cost efficient for preparers.

(c) some users expressed a preference for Alternative 2 (these users hold the view that the equity method is a one-line consolidation method). However, they are also interested in combining paragraphs 16(a)–16(b) of this paper to evaluate the associate—so that, in analysing:

(i) the standalone performance of associates; and

(ii) the associate's performance with the application of Alternative 2,

users will sometimes analyse the equity method earnings to understand the associate's earnings. In doing so, they want to assess the 'gains or losses' arising from these transactions and, therefore, enhancing the disclosure requirements, to require an investor to disclose the amount of the gains or losses from these transactions:

(i) would allow users to adjust for the restricted gain or loss to fit it for their analysis.

(ii) to 'toggle' between elimination and no elimination methods.

20. A few users cautioned that, in non-recurring transactions, without the requirement to restrict the gain or loss, an investor can manage its earnings—for example, the investor could sell assets to an associate at a profit and, without the requirement to eliminate the investor's share of that profit, the profit and loss could be overstated if the transaction is not at a market price.

21. Others said that, restricting gains or losses for non-recurring transactions would lead to more non-cash profits/losses, which are irrelevant to users' valuations (users disregard one-off transactions (or value them differently) in forecasting financial information).

22. Overall, users preferred disclosures over restricting gains in isolation. This is because, as set out in paragraph 17(b) of this paper, the information disclosed for associates in the investor's financial statements does not provide sufficient disaggregation of earnings.