IFRS Accounting

Staff paper

Agenda reference: 13B

IASB® meeting

Date	**January 2023**
Project	**Equity Method**
Topic	**Perceived conflict between IFRS 10 and IAS 28–feedback summary of the outreach activities undertaken**
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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 Agenda Paper 13A of this meeting) 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 summarise:

   (a) informal feedback from accounting firms;

   (b) feedback from the Accounting Standards Advisory Forum (ASAF); and

   (c) feedback from the Global Preparers Forum (GPF).

4. It also includes the staff preliminary analysis on some of the feedback, including:

   (a) Alternative 1—is not requiring elimination entries a move away from the equity method viewed as a one-line consolidation method?[2]

   (b) Alternative 2—are there new structuring opportunities associated with this alternative?

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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.

[2] IFRS Accounting Standards do not identify whether the equity method is a one-line consolidation method or a measurement method. So, for the avoidance of doubt, the staff analysis of this paper does not touch this area as it is out of the Equity Method project's scope.

(c) Alternative 3—is it justifiable to introduce different requirements for sales to customers and to those that are not customers?

(d) Alternative 4—is it justifiable to introduce a distinction between the sale of an asset and of a business?

5. The IASB is not asked to make decisions at this meeting, see the next steps set out in paragraphs 49–50 of Agenda Paper 13A of this meeting. 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 13A.

Structure of this paper

6. The paper is structured as follows:

(a) key message (paragraphs 7–14 of this paper);

(b) summary of feedback (paragraphs 15–18 of this paper); and

(c) staff analysis (paragraphs 19–51 of this paper).

Key message

7. Overall, the feedback received from the outreach discussions did not provide evidence of other viable alternatives (beyond the four alternatives identified) to answer the application question in paragraph 1 of this paper.

Accounting firms

8. The accounting firms generally agree that diversity in practice exists for this application question. Of those, almost all of them expressed support for either:

(a) Alternative 1; or

(b) Alternative 2.

9. They suggest proceeding with an alternative that:

(a) is simple to apply; and

(b) does not introduce new complexities or judgements.

10. One firm raised a concern that Alternative 2 added complexity in that it sets out a hierarchy for applying the Standards, see paragraph 12 of this paper.

ASAF

11. In December 2022, almost all ASAF members provided views on the four alternatives. Of those:

(a) most expressed support for Alternative 2;

(b) many expressed support for Alternative 1; and

(c) some expressed support for Alternative 4.

12. Overall, those ASAF members who supported Alternative 2 did not have concerns about applying the Standards in order; that is demonstrating a hierarchy for applying the Standards. These members did not think Alternative 2 would introduce complexities to the application of IFRS Accounting Standards for other transactions and suggested the IASB could explain that Alternative 2 addressed the transaction set out in the application question.

GPF

13. In November 2022, a few GPF members said the transaction described in the application question is rare in their jurisdictions.

14. Some members expressed a concern that an investor often receives minimal cooperation from its associates and suggested proceeding with an alternative:

    (a) that is the simplest; and

    (b) with the assumption that the investor would be unable to obtain sufficient information required for the equity method of accounting.

Summary of feedback

Accounting firms

15. The following table summarises the informal feedback from accounting firms:

	Support	Challenges
Alternative 1 *(No elimination)*	— Aligned with the reporting entity concept therefore conceptually robust. — Consistent with the loss of control requirements in IFRS 10. — Simple to apply and audit—avoids gathering information needed for elimination entries. — Resolves other application questions relating to 'transactions between an investor and its associate'.	— Is a fundamental change to the equity method procedures in IAS 28. (*See the staff analysis set out in paragraphs 19–30 of this paper*)
Alternative 2 *(Elimination)*	— Results in the least significant change to practice—it does not introduce new concepts or judgements.	— Could lead to structuring opportunities, in some fact patterns, for example, for those transactions that involve a newly established associate. To address such cases, adding guidance is recommended. (*See the staff analysis set out in paragraphs 31–45 of this paper*)
Alternative 3 *(Mixture)*	— Could remove structuring opportunities for those transactions in the scope of IFRS 15 *Revenue from Contracts with Customers.*	— Need to justify the different requirements for sales to customers and to those that are not customers. The distinction results in a different measurement of gain and loss. (*See the staff analysis set out in paragraphs 46–48 of this paper*) — Requires additional processes to monitor and classify transactions.
Alternative 4 *(Reviving 2014 Amendment)*	— Recognises requirements for sale of a business are different from sale of an asset.	— Need to justify the distinction between the sale of an asset and of a business. The distinction results in a different measurement of gain and loss. (*See the staff analysis set out in paragraphs 49–51 of this paper*) — Requires additional processes to monitor and classify transactions.

ASAF

16. The following table summarises the feedback from ASAF:

	Support	Challenges
Alternative 1 *(No elimination)*	— Considered to be the simplest approach. — Prioritises the requirements in IFRS 10 to reflect that the nature of, for example, an asset has changed due to the loss of control in the transaction. — Has technical merits underpinning it.	— Is a fundamental change to the equity method procedures in IAS 28. (*See the staff analysis set out in paragraphs 19–30 of this paper*) — Could lead to inconsistency, as the elimination entries' requirement helps avoid the recognition of unrealised gains and losses. (*See the staff analysis set out in paragraphs 19–30 of this paper*)
Alternative 2 *(Elimination)*	— Demonstrates two IFRS Accounting Standards can be applied simultaneously in addressing specific transactions, also: • no difference between the sale of a business and the sale of an asset; and • this was similarly implied in paragraph BCZ183 of the Basis for Conclusions on IFRS 10. — Strikes the right balance between IFRS 10 and IAS 28. — Consistent with the view that the equity method is a one-line consolidation method. — Results in a faithful representation of the transaction described in the application question (there are technical merits underpinning it).	— Would increase the cost and complexity of applying the equity method. — May be difficult to obtain the information required for the elimination entries' requirements, particularly if the transaction is a business sale, although such a procedure is not new to the equity method.
Alternative 3 *(Mixture)*	— Could achieve simplification in identifying the sale of assets in ordinary activities where partial gains should be recognised.	— Would involve significant complexities in practice. — Could lead to inconsistency, as the elimination entries' requirement helps avoid the recognition of unrealised gains and losses. (*See the staff analysis set out in paragraphs 19–30 of this paper*) — Lacks conceptual merit. (*See the staff analysis set out in paragraphs 46–48 of this paper*)
Alternative 4 *(Reviving 2014 Amendment)*	— Has a consistent logic with IFRS 3 *Business Combinations.* — Would faithfully represent the transaction whilst recognising the individual requirements in IFRS 10 and IAS 28. — Would not require further judgement in determining assets that constitute a business as it is addressed by the clear guidance in IFRS 3.	— Would involve significant complexities in practice. — Lacks conceptual merit to differentiate accounting treatment based on whether the transaction involves a business or not. (*See the staff analysis set out in paragraphs 49–51 of this paper*)

GPF

The four alternatives

17. One GPF member suggested pursuing the alternative that aligns with US GAAP (Alternative 3).

18. Another GPF member said that common practice in their jurisdiction is to view the equity method as a one-line consolidation and doing so often leads to outcomes that provide a faithful representation of the transaction (Alternative 2).

Staff analysis

Alternative 1—is not requiring elimination entries a move away from the equity method viewed as a one-line consolidation method?

Concern

19. As noted in:

    (a) paragraph 41 of Agenda Paper 13C of the September 2022 IASB meeting, some may argue that not requiring elimination entries is a move away from the view that the equity method is a one-line consolidation method (hence the reference to consolidation procedures); and

    (b) paragraphs 15–16 of this paper, a few argued that not requiring elimination entries is a fundamental change to the equity method procedures in IAS 28.

20. To consider this concern, the staff have reviewed whether the elimination entries' requirements were part of the equity method procedures in IAS 28 when it was developed.

Requirements in IAS 28 and IFRS 10

21. 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…

22. Paragraph B86 of IFRS 10 describes the consolidation procedures as:

> Consolidated financial statements:
>
> (a) combine like items of assets, liabilities, equity, income, expenses and cash flows of the parent with those of its subsidiaries.
>
> (b) offset (eliminate) the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary (IFRS 3 explains how to account for any related goodwill).
>
> (c) eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the

group (profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full)…

23. IFRS Accounting Standards do not:

    (a) define the term 'many'. However, to give the IASB an indication of the views in comment letters and from outreach events, and in measuring to what extent of response among respondents, the term '*many*' has been used as '*a small majority or large minority*'.[3]

    (b) identify whether the equity method is a one-line consolidation method or a measurement method.

24. Amongst other procedures, the equity method procedures include:

    (a) equity method goodwill;

    (b) fair value adjustments (basis differences);

    (c) post-acquisition changes; and

    (d) downstream and upstream eliminations entries' requirements.

History of IAS 28

25. By looking at the history of IAS 28, the staff observe that:

    (a) IAS 28 was originally developed (Exposure Draft was issued in July 1986, while the standard was issued in April 1989) *without* having an explicit requirement for the elimination entries.

    (b) until 1997:

        (i) even though paragraph 16 of IAS 28 (reformatted 1994) stated that '*many* of the procedures appropriate for the application of the equity method are similar to the consolidation procedures set out in International Accounting Standard IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*…';

        (ii) the equity method only required those procedures that are related to equity method goodwill, basis differences and post-acquisition changes (see paragraphs 6 and 17 of IAS 28 (reformatted 1994)); and

        (iii) did not have an explicit requirement for the elimination entries.

    (c) in December 1997 and in discussing an issue by the Standing Interpretations Committee (SIC) about to what extent an investor should eliminate unrealised profits and losses resulting from transactions between an investor and its associates, SIC – 3 *Elimination of Unrealised Profits and Losses on Transactions with Associates* was issued.

    (d) in 1999, IAS 28 (revised 1998) explained that SIC – 3 relates to IAS 28.

    (e) in 2005, IAS 28 (2005) replaced SIC – 3 (ie the consensus in SIC-3 has been incorporated into IAS 28, see paragraph 22 of IAS 28 (2005)).

[3] See example from Primary Financial Statements project; AP21A: Feedback summary—Overview.

Principles that underlie IAS 28

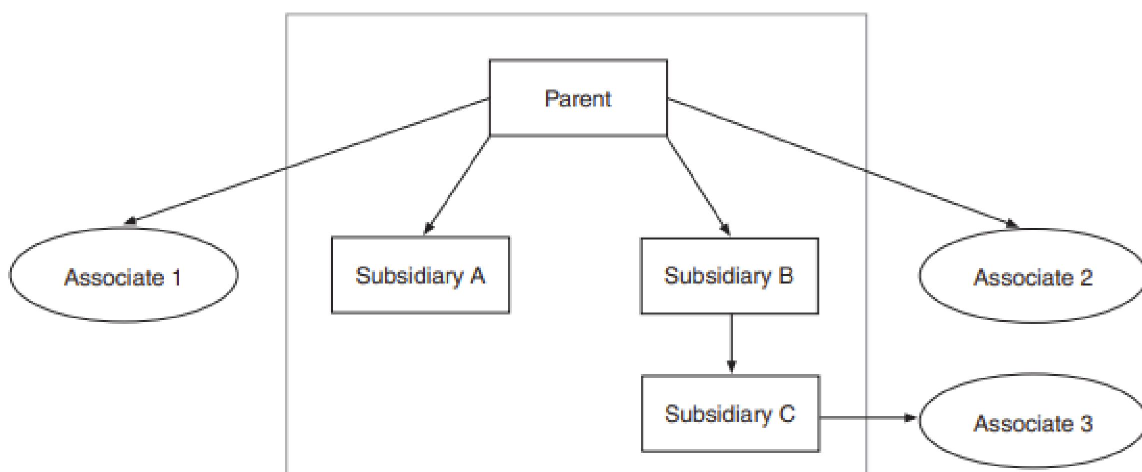
26. At its June 2021 meeting, the IASB discussed principles identified as underlying IAS 28 (these provide a toolbox to help the IASB answer application questions).[4]

27. The staff think two principles are relevant to the boundary of the reporting entity that help assess the objective of elimination entries:

    (a) Principle B—Application of the equity method includes an investor's share in the associate's or joint venture's net asset changes in an investor's statement of financial position.

    (b) Principle C—An investor's share of an associate's or joint venture's net assets is part of the reporting entity.

28. These principles explain the possible thought process for the extended boundary of the reporting entity that would include the changes in the investors' share of the associate's net assets (ie where an associate could sit), see paragraphs 12–32 to Agenda Paper 13C of the September 2022 IASB meeting for further discussion on applying the principles that underlie IAS 28, the objective of elimination entries and interaction with the *Conceptual Framework for Financial Reporting (Conceptual Framework).* The staff also note that the following diagram, in particular the broader line, that sets out in paragraphs IE4–IE8 of the illustrative examples (Example 2 – Associates and subsidiaries) on IAS 24 *Related Party Disclosures* supports such a thought process.



Further considerations and conclusion

29. The staff also observe that:

    (a) although it is not an explicit requirement in IAS 28; impliedly, the gains or losses being eliminated are the unrealised gains or losses (ie which are eliminated only on an asset that remains in the books of an investor or its associate) until they are realised (ie when the asset is sold to a third party or upon depreciating it in subsequent periods). In other words, the process of the elimination entries' requirement is temporary, ie an investor first applies the elimination entries at the transaction date and then, subsequently, reverses the elimination entries when the asset is sold to a third party or upon depreciating it.

[4] See June 2021 IASB Meeting; AP13: Identifying the principles in IAS 28.

(b) IAS 28 does not require elimination of balances such as receivables or payables and deposits or loans to or from an investor's associate.

(c) in deliberating, business combination forward contracts, paragraph BCZ2.42 of the Basis for Conclusions on IFRS 9 *Financial Instruments* explains that the linkage between acquisition accounting and equity method is only in respect of accounting 'methodology' and not in respect of 'principles'.

(d) paragraph 4 of IAS 24 states that intragroup related party transactions and outstanding balances are eliminated but is silent on the elimination entries' requirements for investments in associates.

(e) paragraph B11 of IFRS 12 *Disclosure of Interests in Other Entities* states that in disclosing summarised financial information about the assets, liabilities, profit or loss and cash flows of the subsidiary, the amounts shall be before inter-company eliminations; however, paragraphs B12–B14 of IFRS 12, disclosing summarised financial information for the associates, are silent on whether and how to disclose the impact of the elimination entries' requirements. However, 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, see paragraph 43 of Agenda Paper 13A of this meeting for further details.

30. Considering paragraphs 19–29 of this paper, the staff think that it can be argued:

(a) it is unclear whether the elimination entries' requirements were in scope of the requirement in IAS 28 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' and also when other IFRS Accounting Standards were enhanced or developed (eg IAS 24 and IFRS 12); and

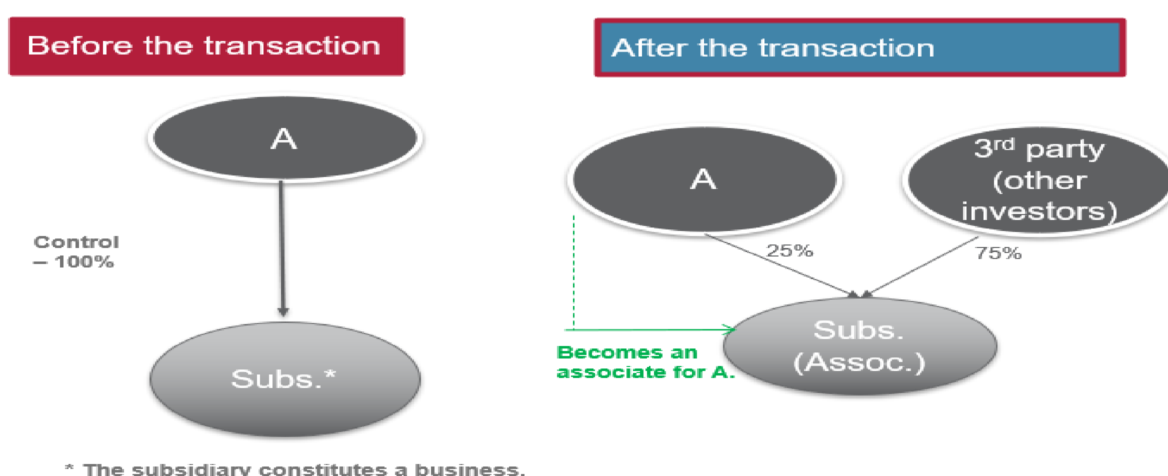
(b) if (a) is correct, not requiring elimination entries is not a move away from the traditional view that the equity method is a one-line consolidation method. In other words, it is doubtful whether the elimination entries' requirements are closely linked to the view that the equity method is a one-line consolidation method.

Alternative 2—are there new structuring opportunities associated with this alternative?

Concern

31. As noted in paragraph 15 of this paper, one accounting firm thinks that Alternative 2 could result in new structuring opportunities, particularly, for those transactions that involve a newly established associate.

32. For example, an investor sells 75% of its wholly owned subsidiary (that constitutes a business) to a third party. The investor receives cash consideration of CU 1,000.

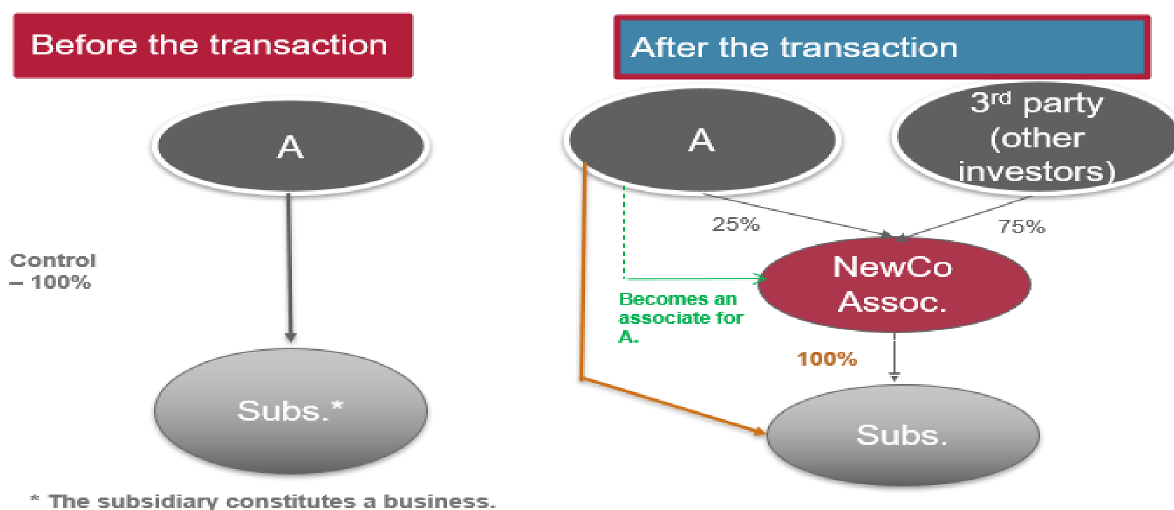


33. Whereas, in another fact pattern, an investor enters into a transaction with a third party, as follows:

    (a) the third party establishes a NewCo.

    (b) the third party contributes CU 1,000 in cash to the NewCo.

    (c) the investor transfers its wholly owned subsidiary (that constitutes a business) directly to the NewCo in exchange for cash consideration of CU 1,000 and a 25% ownership interest in the NewCo.



34. The accounting firm thinks that the two fact patterns are similar in substance but have different legal forms, and could lead to different accounting outcomes, so that:

    (a) the fact pattern set out in paragraph 32 of this paper is *out* of the scope of IAS 28, because the transaction is undertaken with a third party and, therefore, only the IFRS 10 requirements are applied. In other words, full recognition of any gain or loss; whereas

    (b) the fact pattern set out in paragraph 33 of this paper is *in* the scope of IAS 28, because the transaction is undertaken with a NewCo that becomes an investor's associate and, therefore, both IFRS 10 and IAS 28 requirements are applied. In other words, partial recognition of any gain or loss.

Economics of the underlying transaction

35. The staff observe that paragraph 2.12 of the *Conceptual Framework* states that, to provide a faithful representation of an economic phenomenon, an entity should report the substance of that phenomenon. The *Conceptual Framework* includes concepts for reporting the substance of contractual rights and contractual obligations, paragraph 4.59 of the *Conceptual Framework* states that:

> The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance (see paragraph 2.12). In some cases, the substance of the rights and obligations is clear from the legal form of the contract. In other cases, the terms of the contract or a group or series of contracts require analysis to identify the substance of the rights and obligations.

36. The staff note that the fact patterns set out in paragraphs 32–33 of this paper are similar to those set out in paragraph B12 of Appendix B to Agenda Paper 13C of the September 2022 IASB meeting. However, the latter discusses a non-monetary asset, not a business.

37. The staff agree with the accounting firm that considering only the legal form could result in different accounting outcomes and, therefore, could lead to structuring opportunities. The staff, however, continue to hold the view, as set out in paragraphs B15–B16 of Appendix B to Agenda Paper 13C of the September 2022 IASB meeting, that it is important to understand the economics of the underlying transaction and that judgement would, therefore, need to be applied to determine the appropriate accounting.

38. It appears that the substance of both transactions, as set out in paragraphs 32–33 of this paper, is the same (because in both transactions, the investor ends up with: CU 1,000 cash consideration and 25% non-controlling interest in a new entity 'that becomes an associate') and, therefore, both transactions should be accounted for in a similar manner because they are obviously transactions with a third party.

39. In other words, no elimination entities' requirements apply for both fact patterns because both are outside the scope of IAS 28. The staff think that the same should be applied for a fact pattern when 'the receiving associate has been established to facilitate the transfer'.

40. The staff observe that in developing the 2014 Amendment, the IASB explained in paragraph BC190I of the Basis for Conclusions on IFRS 10 that paragraph B99A of IFRS 10 applies to all transactions between an investor and its associate (that is accounted for using the equity method) that result in the loss of control of a subsidiary and, therefore, it does not apply to transactions with third parties, even if the parent retains an investment in the former subsidiary that becomes an associate accounted for using the equity method.[5]

Further considerations and conclusion

41. Although the fact patterns set out in paragraphs 32–33 of this paper are not closely related to the application question under discussion at this meeting; the question we need to answer is: whether there would be a need to develop guidance in IAS 28 to limit (or to help to minimise) such potential structuring opportunities. This is because the requirements in paragraph 28 of IAS 28 apply to a transaction between an investor and an entity that is an associate before the transaction.

42. A possible solution to such potential structuring opportunities could be to require that IAS 28 is applied only when the investor's associate is an existing entity that has been operating before the transaction, and not formed to effect the transaction. However, the staff do not consider that this would be a viable option because:

    (a) it is anti-avoidance for structuring opportunities (in other words, the staff think that any attempt to define 'an associate' to be 'an existing associate that has been operating before the transaction' inherently carries a risk of unintended consequences). The staff think it might not be possible to identify all possible situations in which there could be unintended consequences;

    (b) there might be difficulties defining the meaning of 'existing associate that has been operating before the transaction', and determining how to account for a transaction between an investor and its newly established associate (creating an idea that a transaction with a newly established associate can never be a downstream transaction);

    (c) it may be challenging to minimise such potential structuring opportunities. For example, a new associate could be established because an investor needs an intermediatory in a different jurisdiction or an investor expects that the unrelated investors would transfer subsidiaries to its new associate; and

    (d) it is not closely related to the application question under discussion (because it raises a new application question as to whether a transaction itself is *in* or *outside* the scope of IAS 28) and, therefore, it is outside the scope of the equity method project.

43. On the other hand, the staff believe that an investor might want to achieve a desired accounting outcome (for example, increasing the reported value of assets to obtain future tax benefits) by structuring the transaction to recognise the full gain or loss rather than the partial gain or loss. In other words, the potential structuring opportunities that could arise as set out in paragraph 34 of this paper, might be rarely encountered in practice.

44. Also, the staff do not think that applying Alternative 2 could lead to new structuring opportunities, because it is already the case under the current version of IAS 28 when an investor transfers the control of a distinct non-monetary asset, either as it is or by wrapping it into a subsidiary.

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[5] Paragraph B99A of IFRS 10 states that 'If a parent loses control of a subsidiary that does not contain a business, as defined in IFRS 3, as a result of a transaction involving an associate or a joint venture that is accounted for using the equity method, the parent determines the gain or loss in accordance with paragraphs B98–B99. The gain or loss resulting from the transaction (including the amounts previously recognised in other comprehensive income that would be reclassified to profit or loss in accordance with paragraph B99) is recognised in the parent's profit or loss only to the extent of the unrelated investors' interests in that associate or joint venture. The remaining part of the gain is eliminated against the carrying amount of the investment in that associate or joint venture…'.

45. The staff, however, continue to hold the view, as set out in paragraphs B15–B16 of Appendix B to Agenda Paper 13C of the September 2022 IASB meeting, that it is important to understand the economics of the underlying transaction and that judgement would, therefore, need to be applied to determine the appropriate accounting.

Alternative 3—is it justifiable to introduce different requirements for sales to customers and to those that are not customers?

Concern

46. As noted in paragraphs 15–16 of this paper, a few argued that, if Alternative 3 is taken forward the IASB should justify why there are different requirements for sales in the scope of IFRS 15 and those that are not in scope of IFRS 15; the distinction results in a different measurement of gain and loss.

47. The staff observe that, in developing IFRS 15, the IASB reasoned that transfers of non-financial assets that are not an output of an entity's ordinary activities are more like transfers of assets to customers.

48. The staff also note that the IASB discussed this within the context of an entity that transfers non-financial assets within the scope of IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* or IAS 40 *Investment Properties*, for which the IASB decided to require the application of the requirements in IFRS 15 for control and measurement for these disposals.[6]

Alternative 4—is it justifiable to introduce a distinction between the sale of an asset and of a business?

Concern

49. As noted in paragraphs 15–16 of this paper, a few argued that, in applying Alternative 4, there might be a need to justify a distinction between the sale of an asset and of a business, for which the distinction results in the different measurement of gain and loss and lacks conceptual merit.

50. The staff agree with those who raised this concern and observe that, in developing IFRS 10, the IASB decided that the loss of control of a subsidiary is, from the group's perspective, the loss of control over some of the group's individual assets and liabilities. Accordingly, the general requirements in IFRSs should be applied in accounting for the derecognition from the group's financial statements of the subsidiary's assets and liabilities.[7]

51. The staff, therefore, continue to argue, as set out in paragraphs B25–B29 of Appendix B to Agenda Paper 13C of the September 2022 IASB meeting, that there is no reason for not aligning the accounting between assets and businesses when it comes to derecognition and losing control—because:

    (a) derecognising a business applying IFRS 10 requires removing the carrying amounts of the former subsidiary's assets (including any goodwill) and liabilities from the consolidated financial statements.

    (b) derecognising an asset requires also, applying IAS 16, removing the asset's carrying amount from the financial statements.

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[6] See paragraphs BC500–BC501 of the Basis for Conclusions on IFRS 15.

[7] See paragraph BCZ183 of the Basis for Conclusions on IFRS 10.