Capital Markets Advisory Committee meeting

Date	**9 March 2023**
Project	**Equity Method**
Topic	**Transactions between an investor and its associate–does restricting gains or losses on these transactions affect the equity method earnings quality**
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Objective of this paper

1. The objective of this paper is to ask Capital Markets Advisory Committee (CMAC) members for views on, when evaluating equity-accounted investments:

   (a) whether restricting the gain or loss on a sale of a subsidiary from an investor to its associate affects the equity method earnings quality and if so, how does it affect users' decision-making.

   (b) how the information would be used if an investor disclosed the gains or losses on the transactions between itself and its associate.

2. In this paper the term:

   (a) 'investor' refers to an equity method investor, that is an entity (ie a company) that has significant influence over another entity but not control; and

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

Background

3. At its September 2022 and January 2023 meetings, the International Accounting Standards Board (IASB) discussed the requirements for transactions between an investor and its associate, specifically a transaction in which an investor sells a subsidiary to its associate and whether an investor should:

   (a) recognise in full gains or losses from these transactions with its associate; or

   (b) restrict the gains or losses from these transactions, that is reduce the gain for its related interest applying paragraph 28 of IAS 28 *Investments in Associates and Joint Ventures*.[1] [2]

'Upstream' and 'Downstream' transactions

4. 'Upstream' transactions are, for example, sales of assets from an associate to the investor.

5. 'Downstream' transactions are, for example, sales of assets from the investor to its associate.

[1] See September 2022 IASB meeting; AP13C and January 2023 IASB meeting; AP13A and AP13B.
[2] Paragraphs 7–18 of AP13B to the January 2023 IASB meeting summarised informal feedback from accounting firms, feedback from the Accounting Standards Advisory Forum (ASAF) and feedback from the Global Preparers Forum (GPF).

Gains or losses from 'upstream' and 'downstream' transactions

6. Paragraph 28 of IAS 28 requires that gains and losses from 'upstream' and 'downstream' transactions between an investor and its associate are recognised in the investor's financial statements to the extent of the unrelated investors' interests in the associate. Put simply, an investor reduces its share of gains or losses resulting from an upstream or a downstream transaction in proportion to its ownership share in the associate. For example, an investor sells a property to its associate and recognised in its financial statements a disposal gain of CU100. Assuming the investor owns 20 per cent of the associate the investor would restrict that gain to CU80.

7. The investor recognises that part of the gain that has been restricted (ie CU20) either when the property is sold to a third party or over the useful life of the property.

Objective of restricting the gains or losses

8. In reporting groups the investor controls the subsidiary and thereby its assets and liabilities. An investor cannot recognise a gain or loss on selling or buying to or from its subsidiary as they are the same reporting entity, therefore such gains and losses are eliminated in the financial statements. The same cannot be said when the equity method is applied, as an associate is not controlled by the parent. In these circumstances the question is whether the gains and losses should be restricted.

Outline of two of the alternatives discussed by the IASB

9. At its January 2023 meeting, the IASB asked the staff to continue exploring two alternatives:

   (a) an alternative that 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, gains and losses of these transactions are not restricted (*Alternative 1 'No elimination'*).

   (b) an alternative that 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, gains and losses of these transactions are restricted (*Alternative 2 'Elimination'*).

Illustrative examples

10. To demonstrate how restricting the gains or losses affect the investors' financial statements two examples are set out in Appendix A of this paper:

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

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

11. For simplicity, the illustrative examples have been developed based on selling or buying assets, although the mechanics would be the same for other types of transactions. The illustrative examples, include the relevant notes that would be included in the financial statements of an investor, particularly the:

    (a) statement of financial position (the 'Balance Sheet');

    (b) statement of comprehensive income (the 'P&L');

    (c) statement of cash flows (the 'Cash Flow Statement'); and

    (d) notes to financial statements, in accordance with paragraph 18 of IAS 24 *Related Party Disclosures*.

12. Paragraph 18 of IAS 24 requires an investor to disclose the amount of the transactions between an investor and its associate. If Alternative 1 ‘No elimination’ is taken forward (as set out in paragraph 9(a) of this paper), the staff are considering recommending to the IASB an investor also discloses the amount of the gain or loss arising from transactions between an investor and its associate. See the extract of the notes to financial statements as set out in the illustrative examples in Appendix A of this paper.

13. It should be noted that, in both illustrative examples, restricting the gains or losses results in:

    (a) a lower carrying amount of the investment in ABC in earlier years, particularly in Year 2;

    (b) a lower profit in earlier years, particularly in Year 2, but a higher profit over the later years; and

    (c) there is no change to the cash flow statement.[3]

Questions (and points for discussion) to CMAC members

1. To discuss – your approach to analysis and valuation when evaluating investors’ financial statements that have investments in equity-accounted associates. For example, do you evaluate/analyse these investments separately?

2. When analysing an investor’s financial statements that has an investment in an equity-accounted associate, what source of information would you prioritise in order to analyse the associate’s performance:

    (a) the associate’s earnings as reported in the investor’s financial statements (ie financial results prepared by applying the equity method, that may (or may not) include restricting gains and losses for transactions with the associate, refer to question 3); or

    (b) the associate’s earnings as reported in its own financial statements?

3. The illustrative examples in Appendix A of this paper are intended to help you compare and contrast the two alternatives set out in paragraph 9 of this paper. We would like to discuss the different financial reporting outcomes in the examples to help us understand which alternative would provide you with the more useful information and why?

4. As noted in paragraph 12 of this paper, the staff are recommending that the IASB would require an investor to disclose the amount of the gain or loss arising from transactions between an investor and its associate (not only the amount of the transactions). We would like to discuss your view on the staff recommendation and understand how you would use this information in your analysis of financial statements.

[3] See footnotes 4–8 of this paper for further explanations.

Appendix A—Illustrative examples: Transactions between an investor and its associate

Illustrative example 1 —'Downstream' transaction

A1. A downstream transaction in which:

(a) investor XYZ acquires a 20% share in investee ABC at the beginning of year 1 for a consideration CU250 and obtains significant influence.

(b) at that date, the book value of assets and liabilities of ABC is equal to their fair value, which is CU1,000.

(c) the excess over the costs of investment and XYZ share of the fair value in ABC net assets is CU50 (CU250 - (CU1000*20%)). XYZ does not attribute this to any specific identifiable asset and it is therefore recognised as equity method goodwill.

(d) the profit of ABC for year 1 is CU100.

(e) at the beginning of year 2, XYZ sells to ABC an investment property for CU2,000; XYZ's net book value is CU1,800.

(f) ABC estimates that investment property has an 8-year life and depreciates on a straight-line basis.

(g) the profit of ABC for years 2 to year 9 is CU500.

(h) ABC does not declare dividends in these years.

A2. It should be noted that:

(a) extracts labelled ‘gains *are not* restricted’ illustrate the transaction as if Alternative 1 ‘No elimination’ is taken forward (as set out in paragraph 9(a) of this paper).

(b) extracts labelled ‘gains *are* restricted’ illustrate the transaction as if Alternative 2 ‘Elimination’ is taken forward (as set out in paragraph 9(b) of this paper).

Extract | XYZ – Balance Sheet

Gains are not restricted

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9
ASSETS **Non-current**									
Investment property	1,800	–	–	–	–	–	–	–	–
Investment in ABC	270	370	470	570	670	770	870	970	1,070
Current									
Cash	600	2,600	2,600	2,600	2,600	2,600	2,600	2,600	2,600

Gains are restricted

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9
ASSETS **Non-current**									
Investment property	1,800	–	–	–	–	–	–	–	–
Investment in ABC	270	335[4]	440	545	650	755	860	965	1,070
Current									
Cash	600	2,600	2,600	2,600	2,600	2,600	2,600	2,600	2,600

[4] CU335 = CU370 (Investment in ABC) - CU40 (CU200 x 20% (restricting XYZ's portion of the disposal gain)) + CU5 (recognising the restricted proportion of the gain over the useful life of the investment property; CU40 / 8 years).

Extract | XYZ – P&L

Gains are not restricted	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9
Revenue (investment property rentals)	600	–	–	–	–	–	–	–	–
Other Income (gain on sale of investment property)	–	200	–	–	–	–	–	–	–
Depreciation	(200)	–	–	–	–	–	–	–	–
Share of profit of associates	20	100	100	100	100	100	100	100	100
Profit before taxation	**420**	**300**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Gains are restricted	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9
Revenue (investment property rentals)	600	–	–	–	–	–	–	–	–
Other Income (gain on sale of investment property)	–	160[5]	–	–	–	–	–	–	–
Depreciation	(200)	–	–	–	–	–	–	–	–
Share of profit of associates	20	105[6]	105	105	105	105	105	105	105
Profit before taxation	**420**	**265**	**105**	**105**	**105**	**105**	**105**	**105**	**105**

[5] CU160 = CU200 (full gain on sale investment property - CU40 (CU200 x 20% (restricting XYZ's portion of the disposal gain)).
[6] CU105 = CU100 (share of profit of ABC) + CU5 (recognising the restricted proportion of the gain over the useful life of the investment property; CU40 / 8 years).

Extract | XYZ – Cash Flow Statement

Gains are not restricted									
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**
Cash flows from operating activities									
Profit before taxation	420	300	100	100	100	100	100	100	100
Adjustments for:									
Depreciation	200	–	–	–	–	–	–	–	–
Gain on sale of Investment property	–	(200)	–	–	–	–	–	–	–
Share of profit of associates	(20)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)
Net cash from operating activities	**600**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Cash flows from investing activities									
Acquisition of ABC	(250)	–	–	–	–	–	–	–	–
Proceed from sale of investment property (payment from ABC)	–	2,000	–	–	–	–	–	–	–

Extract | XYZ – Cash Flow Statement

Gains are restricted									
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**
Cash flows from operating activities									
Profit before taxation	420	265	105	105	105	105	105	105	105
Adjustments for:									
Depreciation	200	–	–	–	–	–	–	–	–
Gain on sale of investment property	–	(160)	–	–	–	–	–	–	–
Share of profit of associates	(20)	(105)	(105)	(105)	(105)	(105)	(105)	(105)	(105)
Net cash from operating activities	**600**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Cash flows from investing activities									
Acquisition of ABC	(250)	–	–	–	–	–	–	–	–
Proceed from sale of investment property (payment from ABC)	–	2,000	–	–	–	–	–	–	–

Extract | XYZ – Notes to financial statements – Related parties

Gains are not restricted									
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**
Transaction values									
Sale of investment property									
ABC	–	2,000	–	–	–	–	–	–	–

Gains are restricted
Same disclosure above as if gains are not restricted.

Extract | XYZ – Notes to financial statements – Related parties

(Staff possible recommendation to enhance IAS 24 disclosure requirements)

Gains are not restricted									
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Year 9**
Transaction values									
Sale of investment property									
ABC	–	2,000	–	–	–	–	–	–	–
Gains (or losses) on transactions									
Sale of investment property									
ABC	–	200	–	–	–	–	–	–	–

Illustrative example 2 —'Upstream' transaction

A3. An upstream transaction in which:

(a) investor XYZ acquires a 20% share in investee ABC at the beginning of year 1 for a consideration CU250 and obtains significant influence.

(b) at that date, the book value of assets and liabilities of ABC is equal to their fair value, which is CU1,000.

(c) the excess over the costs of investment and XYZ share of the fair value in ABC net assets is CU50 (CU250 - (CU1000*20%)). XYZ does not attribute this to any specific identifiable asset and is recognised as equity method goodwill.

(d) the profit of ABC for year 1 is CU200.

(e) at the beginning of year 2, ABC sells to XYZ equipment for a consideration CU500. At that date, net book value of such equipment in ABC books is CU400, ABC recognises a profit of CU100.

(f) XYZ estimates that the equipment has a 5-year life and plans to depreciate it on a straight-line basis.

(g) the profit of ABC for year 2 is CU250 and for each year from year 3 to year 6 is CU150.

(h) ABC does not declare dividends in these years.

A4. It should be noted that:

(a) extracts labelled ‘gains *are not* restricted’ illustrate the transaction as if Alternative 1 ‘No elimination’ is taken forward (as set out in paragraph 9(a) of this paper).

(b) extracts labelled ‘gains *are* restricted’ illustrate the transaction as if Alternative 2 ‘Elimination’ is taken forward (as set out in paragraph 9(b) of this paper).

Extract | XYZ – Balance Sheet

Gains are not restricted						
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
ASSETS **Non-current**						
PPE (equipment)	–	400	300	200	100	–
Investment in ABC	290	340	370	400	430	460
Current						
Cash	600	150	200	250	300	350

Gains are restricted						
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
ASSETS **Non-current**						
PPE (equipment)	–	400	300	200	100	–
Investment in ABC	290	324[7]	358	392	426	460
Current						
Cash	600	150	200	250	300	350

[7] CU324 = CU340 (Investment in ABC) - CU20 (CU100 x 20% (restricting XYZ's portion of ABC's earning of disposing the equipment)) + CU4 (recognising the restricted proportion of the gain over the useful life of the equipment; CU20 / 5 years).

Extract | XYZ – P&L

Gains are not restricted	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Revenue (ordinary activities)	100	150	150	150	150	150
Depreciation	–	(100)	(100)	(100)	(100)	(100)
Share of profit of associates	40	50	30	30	30	30
Profit before taxation	**140**	**100**	**80**	**80**	**80**	**80**

Gains are restricted	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Revenue (ordinary activities)	100	150	150	150	150	150
Depreciation	–	(100)	(100)	(100)	(100)	(100)
Share of profit of associates	40	34[8]	34	34	34	34
Profit before taxation	**140**	**84**	**84**	**84**	**84**	**84**

[8] CU34 = CU50 (share of profit of ABC) - CU20 (CU100 x 20% (restricting XYZ's portion of ABC's earning of disposing the equipment) + CU4 (recognising the restricted proportion of the gain over the useful life of the equipment; CU20 / 5 years).

Extract | XYZ – Cash Flow Statement

Gains are not restricted						
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Cash flows from operating activities						
Profit before taxation	140	100	80	80	80	80
Adjustments for:						
Depreciation	–	100	100	100	100	100
Share of profit of associates	(40)	(50)	(30)	(30)	(30)	(30)
Net cash from operating activities	**100**	**150**	**150**	**150**	**150**	**150**
Cash flows from investing activities						
Acquisition of ABC	(250)	–	–	–	–	–
Acquisition of PPE equipment (payment to ABC)	–	(500)	–	–	–	–

Extract | XYZ – Cash Flow Statement

Gains are restricted						
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Cash flows from operating activities						
Profit before taxation	140	84	84	84	84	84
Adjustments for:						
Depreciation	–	100	100	100	100	100
Share of profit of associates	(40)	(34)	(34)	(34)	(34)	(34)
Net cash from operating activities	**100**	**150**	**150**	**150**	**150**	**150**
Cash flows from investing activities						
Acquisition of ABC	(250)	–	–	–	–	–
Acquisition of PPE equipment (payment to ABC)	–	(500)	–	–	–	–

Extract | XYZ – Notes to financial statements – Related parties

Gains are not restricted						
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Transaction values						
Purchase of PPE						
ABC	–	500	–	–	–	–

Gains are restricted
Same disclosure above as if gains are not restricted.

Extract | XYZ – Notes to financial statements – Related parties

(Staff possible recommendation to enhance IAS 24 disclosure requirements)

Gains are not restricted						
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Transaction values						
Purchase of PPE						
ABC	–	500	–	–	–	–
Gains (or losses) on transactions						
Purchase of PPE						
ABC	–	100	–	–	–	–