Staff paper

Agenda reference: 13B

IASB® meeting

Date	**March 2023**
Project	**Equity Method**
Topic	**Perceived conflict between IFRS 10 and IAS 28**
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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 the four alternatives, in particular it discussed:

   (a) further considerations of applying the four alternatives; and

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

[1] See September 2022 IASB meeting; AP13C.

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

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

   (a) continue exploring two of the four alternatives discussed at 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.

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’, ‘restricting gains or losses’, ‘partial gains or losses’ or ‘proportionate elimination’ 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 ask the IASB to:

   (a) consider the staff analysis of Alternative 1 and Alternative 2; and

   (b) decide which of the alternatives to propose to answer the application question.

6. Agenda Paper 13C *Perceived conflict between IFRS 10 and IAS 28–feedback summary on the outreach activities undertaken with users* of this meeting summarises the feedback 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.

Staff recommendation

7. The staff recommend the IASB propose amendments to:

(a) IAS 28 to require an investor to recognise the full gain or loss on all transactions with its associate (*Alternative 1 'No elimination'*); and

(b) IAS 24 *Related Party Disclosures* to require an investor to disclose the gain or loss from transactions with its associate (in addition to the amount of the transactions).

8. Paragraphs 7(a)–7(b) of this paper are collectively referred to in this paper as (*Alternative 1 with enhanced disclosure*).

Structure of this paper

9. The paper is structured as follows:

(a) description of the application question (paragraphs 10–12 of this paper);

(b) summary of the four alternatives (paragraphs 13–17 of this paper);

(c) narrowing the alternatives (paragraphs 18–19 of this paper);

(d) staff analysis of Alternative 1 and Alternative 2 (paragraphs 20–94 of this paper):

(i) conceptual reasons (paragraphs 24–77 of this paper);

(ii) practical reasons (paragraphs 78–90 of this paper); and

(iii) cost-benefit considerations (effects analysis) (paragraphs 91–94 of this paper); and

(e) question to the IASB.

Description of the application question

10. The application question in paragraph 1 of this paper asks about 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 gains or losses 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 gains or losses 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).[3]

11. The following diagram illustrates the sale of a subsidiary from an investor (with and without retaining an interest in the former subsidiary) to its associate, before and after the transaction.

[3] For simplicity, as an example of how the mechanics of restricting gains or losses work: The restricted gains or losses at the transaction date should be recognised in future periods when the asset is sold to a third party or over the useful life of the asset.

12. For further details on the history of this perceived conflict, including the amendment issued in 2014 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (2014 Amendment) see Appendix A of Agenda Paper 13C of the September 2022 IASB meeting.

Summary of the four alternatives

13. The following table summarises the four alternatives to answer the application question discussed by the IASB at its September 2022 meeting.

Recognition of **full** gains or losses *versus* **restricting** gains or losses	**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[4]			
	NOT an output of investor's ordinary activities[5]		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)[6]	Unclear[7]	Policy choice (full/partial)[8]	Partial

[4] In other words, whether a transaction is in the scope of IFRS 15 or not.

[5] 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.

[6] Most audit practice manuals state that an investor 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.

[7] Many audit practice manuals do not have specific guidance, while some allowed full gains or losses (ie applying the 2014 Amendment).

[8] Many audit practice manuals provide an accounting policy choice, while some does not have specific guidance.

Alternative 1—apply IFRS 10 to all contributions and sales

14. Alternative 1 would require an investor to recognise in *full* the gains or losses on all transactions with its associate, regardless of whether they constitute assets or businesses or are housed or not in a subsidiary (*Alternative 1 'No elimination'*).

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

15. Alternative 2 would require an investor to recognise *partial* gains or losses on all transactions with its associate, regardless of whether they constitute assets or businesses or are housed or not in a subsidiary—this alternative requires IFRS 10 and IAS 28 to be applied to these transactions (*Alternative 2 'Elimination'*).

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

16. Alternative 3 would require an investor to recognise:

    (a) the *full* gains or losses on transactions outside the scope of IFRS 15 *Revenue from Contracts with Customers*.

    (b) *partial* gains or losses on transactions in the scope of IFRS 15.

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

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

    (a) the *full* gains or losses when a transaction constitutes a business; and

    (b) *partial* gains or losses when a transaction constitutes an asset.

Narrowing the alternatives

18. As noted in paragraphs 2–3 of this paper, the initial feedback provided evidence that the IASB should proceed with either Alternative 1 or Alternative 2. At its January 2023 meeting the IASB discussed the feedback that:

    (a) Alternative 3 could be perceived as inconsistent with the IASB's views in developing IFRS 15. 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. Therefore, drawing a line for contracts in the scope of IFRS 15 and those that are not in the scope of IFRS 15 would be difficult to justify.[9]

    (b) Alternative 4 could be perceived as inconsistent with the IASB's views in developing IFRS 10. 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 IFRS Accounting Standards should be applied in accounting for the derecognition from the group's financial statements of the subsidiary's assets and liabilities. Therefore, drawing a line for different requirements between the sale of an asset and of a business would be difficult to justify.[10]

19. Alternative 3 and Alternative 4 were viewed as introducing unnecessary complexity because judgement would be needed to decide which requirements to apply to a transaction. Consequently, the IASB asked the staff to continue exploring Alternative 1 and Alternative 2 to answering the application question.

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

[10] See paragraph BCZ183 of the Basis for Conclusions on IFRS 10 and paragraphs B25–B29 of Appendix B to Agenda Paper 13C of the September 2022 IASB meeting.

Staff analysis of Alternative 1 and Alternative 2

Approach to the staff analysis

20. Agenda Paper 13C of the September 2022 IASB meeting, particularly paragraphs 36–54, set out the rationale for Alternative 1 and Alternative 2 and provided:

    (a) the staff's preliminary analysis;

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

    (c) advantages and disadvantages of the alternatives.

21. Agenda Paper 13A and Agenda Paper 13B of the January 2023 IASB meeting set out further considerations and the feedback from the initial outreach.

22. In the next sections of this paper, the staff have drawn on the rationale from the previous agenda papers noted in paragraphs 20–21 of this paper. The staff have grouped the analysis into three categories:

    (a) conceptual reasons;

    (b) practical reasons; and

    (c) cost-benefit considerations (effects analysis).

23. The staff acknowledge that assessing the practical reasons alongside the effects analysis could be perceived as overlapping. However, the staff think given the feedback from preparers and users it is helpful to have separate analysis. This is because together the analysis provides a holistic assessment that helps the IASB decide on this application question.

Conceptual reasons

Principles that underlie IAS 28

24. At its June 2021 meeting, the IASB discussed:

 (a) principles identified as underlying IAS 28 (these aim to provide a toolbox to help the IASB answer application questions); and

 (b) the approach to answering application questions that cannot be resolved using the identified principles in (a)—that is, by analogising and considering the applicability of the requirements in IFRS Accounting Standards dealing with similar and related issues and the definitions, recognition criteria and measurement concepts in the *Conceptual Framework for Financial Reporting (Conceptual Framework).*[11]

25. The staff encountered difficulties in identifying underlying principles to answer the application question in this paper because it involves the interaction of the requirements in IAS 28 with other IFRS Accounting Standards, such as IFRS 3 *Business Combinations* and IFRS 10. The staff have, therefore, considered a combination of paragraphs 24(a)–24(b) of this paper, including the boundary of the reporting entity and the objective of the elimination entries to help answer the application questions on transactions between an investor and its associate.

26. The staff think two of the identified principles are relevant to the boundary of the reporting entity and 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.

[11] See June 2021 IASB Meeting; AP13: Identifying the principles in IAS 28 and the IASB *Update* June 2021.

Interaction with the Conceptual Framework and requirements in IFRS Accounting Standards

27. Paragraph 3.11 of the *Conceptual Framework* states that:

> Sometimes one entity (**parent**) has **control** over another entity (**subsidiary**). If a reporting entity comprises both the parent and its subsidiaries, the **reporting entity's financial statements** are referred to as '**consolidated financial statements**'…

28. Paragraph 3.15 of the *Conceptual Framework* states that:

> Consolidated financial statements provide information about the assets, liabilities, equity, income and expenses of **both the parent and its subsidiaries** as a **single reporting entity**…

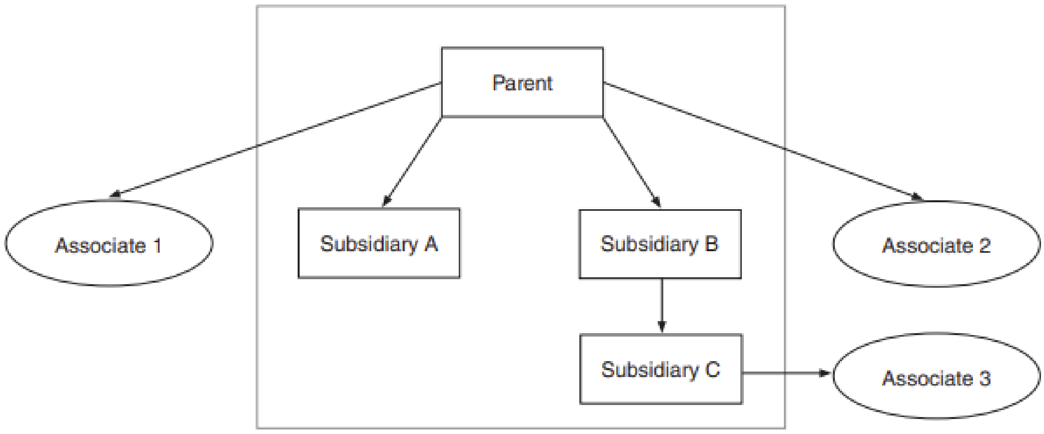
29. Appendix A of IFRS 10 states that:

> **Group** is a **parent and its subsidiaries**.

30. Paragraph BC28 of the Basis for Conclusions on IAS 28 explains that:

> …In the case of loss of control, the cessation of the parent-subsidiary relationship results in the derecognition of assets and liabilities because the composition of the group changes. If joint control or **significant influence is lost** the composition of the group is **unaffected**.

31. The following diagram, from paragraphs IE4–IE8 of the illustrative of IAS 24, illustrates an associate's relationship to the group.



An associate and the group

32. Based on paragraphs 24–31 of this paper, the staff think there are two possibilities on how an associate relates to a group:

    (a) the existence of a group and an extended reporting entity—principles set out in paragraph 26 of this paper explain the possibility for an extended boundary of the reporting entity that includes the changes in the investors' share of the associate's net assets[12]; or

    (b) the existence of one reporting entity, which is a reporting group—paragraphs 27–31 of this paper apply. A group's investment in an associate is considered an asset of the group, similar to an investment in a financial instrument in the scope of IFRS 9 *Financial Instruments*.[13]

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[12] See paragraphs 12–16 to Agenda Paper 13C of the September 2022 IASB meeting for further discussion.

[13] In other words, a group's investment in an associate or a financial instrument, both are not part of the reporting group (that includes a parent and its subsidiaries only). However, they are still the group's assets (as investments in other entities). For example, an investor:

(a) 20% interest that is presumed to give significant influence is an investment in associate in accordance with IAS 28.
(b) smaller interest than in (a), eg 19%, that does not give significant influence is a financial asset in accordance with IFRS 9.

33. In the staff's view, the two possibilities regarding the relationship between the associate and the group, result in the same outcome. This is because under either possibility, it is clear that the associate is not part of the group. That is, control is the appropriate basis for determining the boundary of the group, and an associate is not part of the group.

34. The staff also observe that, as part of the *Primary Financial Statements* project, the IASB has tentatively decided:

(a) to withdraw the proposal in the exposure draft to distinguish between integral and non-integral associates and joint ventures; and

(b) to present income and expenses from associates and joint ventures accounted for using the equity method in the investing category in the statement of profit or loss.[14]

Objective of the elimination entries and the history of IAS 28

35. In a group, the parent controls the subsidiary and thereby the assets and liabilities of the subsidiary. A parent cannot recognise gains or losses on selling or buying to or from its subsidiary as consolidated financial statements report the parent and the subsidiary as a single economic entity, therefore such gains or losses are eliminated in the consolidated financial statements. The same cannot be said for associates, as an associate is not part of group and is not controlled by the parent. In these circumstances, it is more challenging to identify why gains or losses are restricted applying IAS 28.[15]

[14] See:
- October 2021 IASB Meeting; AP21A and the IASB *Update* October 2021;
- December 2021 IASB Meeting; AP21B and the IASB *Update* December 2021; and
- September 2022 IASB Meeting; AP21B and the IASB Update September 2022.

[15] See paragraphs 17–31 to Agenda Paper 13C of the September 2022 IASB meeting for further discussion.

36. The staff think[16]:

   (a) it is unclear whether restricting gains or losses was part of the requirements 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' when IAS 28 was first issued; and

   (b) if (a) is correct, not restricting gains or losses is not a move away from the view that the equity method is a one-line consolidation method. Therefore, the argument is relevant.

37. The staff have also considered the rationale supporting SIC – 3 *Elimination of Unrealised Profits and Losses on Transactions with Associates*. In doing so, the staff observe that paragraph 6 of SIC – 3 explained that:

> *IAS 31.32 Financial Reporting of Interests in Joint Ventures (1994)* allows a venturer to report its interest in a **jointly controlled entity** using the **equity method**. IAS 31.39 and .40 require the **proportionate elimination** of intercompany profits and losses resulting from transactions with a joint venture. The **rationale of these provisions** for entities under joint control regarding the elimination of intercompany profits and losses **applies to entities under significant influence** as well…

38. However, the staff observe that the requirement in IAS 31, to account for a venturer's interest in a jointly controlled entity (JCE), was proportionate consolidation whereby a venturer's share of each of the assets, liabilities, income and expenses of a JCE was combined on a line-by-line basis with similar items in the venturer's financial statements or reported as separate line items in the venturer's financial statements.

39. Paragraph 33 of IAS 31 stated that, as an alternative treatment, some venturers apply the equity method to JCE only by those who:

[16] See paragraphs 19–29 to Agenda Paper 13B of the January 2023 IASB meeting for further discussion.

(a) argue that it is inappropriate to combine controlled items with jointly controlled items; and

(b) believe that venturers have significant influence, rather than joint control, in a JCE.

40. Paragraphs 26 and 33 of IAS 31 also stated that IAS 31 did not recommend the use of the equity method because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a JCE, that is, control over the venturer's share of the future economic benefits through its share of the assets and liabilities of the venture. Paragraph 39 of IAS 31 stated that:

(a) when a venturer sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction should reflect the substance of the transaction; and

(b) while the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer should recognise only that portion of the gain which is attributable to the interests of the other venturers.

41. Paragraphs 37–40 of this paper raise the question: whether the rationale behind restricting gains or losses was about the application of proportionate consolidation or both proportionate consolidation and equity method.

42. The staff think that it is unclear whether restricting gains or losses was intended to apply to the equity method. This is because the rationale that underlies proportionate consolidation assumes that such a transaction is conducted with the other venturers, and that each venturer controls its share the assets, liabilities, income and expenses of a JCE.

43. If the argument in paragraph 42 of this paper is correct, and given that the IASB in developing IFRS 11 *Joint Arrangements* concluded that proportionate consolidation is not an appropriate method to account for interests in joint arrangements when the parties have neither rights to the assets, nor obligations for the liabilities, relating to

the arrangement, restricting gains or losses was not about application of the equity method; instead, it was about the rationale supporting proportionate consolidation. The staff, therefore, think that expanding the requirement of elimination entries under Alternative 2 lacks conceptual merit.

Other requirements in IFRS Accounting Standards[17]

44. An investor losing control of a subsidiary but retaining significant influence (or from having non-monetary asset to equity accounted investment):

    (a) recognises the full gain or loss on loss of control of a subsidiary—the investor applies the deconsolidation requirements in IFRS 10 and, as part of measuring the gain or loss on the transaction, measures any investment retained at the fair value.

    (b) recognises the full gain or loss on exchanging a non-monetary asset for significant influence in an associate—the investor applies the derecognition requirements in IAS 16 *Property, Plant and Equipment* and, as part of measuring the gains or losses on the transaction, measures the consideration in accordance with IFRS 15 requirements (in which case, the non-cash consideration, including any equity investment obtained, is measured at fair value).

45. The loss of control in accordance with IFRS 10 is a significant economic event—the parent-subsidiary relationship ceases to exist and an investor-investee relationship begins (that differs significantly from the former parent-subsidiary relationship). Similarly, the loss of control of a non-monetary asset in the scope of IAS 16, in exchange for an equity accounted investment is a significant economic event, because the entity no longer controls the asset and the nature of the asset changes from a non-financial asset (property, plant and equipment "PPE" that is a non-monetary asset) to a financial instrument (investment in an associate).

[17] See paragraphs B1–B16 of Appendix B to Agenda Paper 13C of the September 2022 IASB meeting for further details.

46. The staff note that, regardless of whether losing control of a subsidiary or a non-monetary asset, IFRS Accounting Standards require:

(a) the full gains or losses to be recognised in profit or loss on:

(i) loss of control of a subsidiary; or

(ii) loss of control of a non-monetary asset; and

(b) if an investor obtained an investment (in exchange for the subsidiary or the non-monetary asset), such an investment is measured at fair value.

Feedback from accounting firms, ASAF and GPF

47. The following table summarises the feedback related to the conceptual merits of Alternative 1 and Alternative 2 from the accounting firms, ASAF and GPF.[18]

Supporters of Alternative 1 *(No elimination)*	Supporters of Alternative 2 *(Elimination)*
— It aligned with the reporting entity concept in the *Conceptual Framework*. — It is consistent with the loss of control requirements in IFRS 10; the nature of the asset has changed due to the loss of control in the transaction.	— It demonstrates how two IFRS Accounting Standards are applied simultaneously to a transaction.

Feedback outreach with users

48. Paragraphs 49–54 of this paper are a summary of the feedback from outreach with users. For further details on the feedback from outreach with users, refer to Agenda Paper 13C *Perceived conflict between IFRS 10 and IAS 28–feedback summary of the outreach activities undertaken with users* of this meeting.

49. Users said that, when evaluating the financial statements of an investor with investments that are equity-accounted associates, they have different priorities

18 See paragraphs 7–18 of Agenda Paper 13B to the January 2023 IASB meeting for further details.

depending on the materiality of the associate. Materiality is assessed on whether the associate contributes significantly to investor's earnings/income.

50. 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;[19] 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.

51. 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.

52. 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:

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

(a) it complements the disclosure requirements in IAS 24, 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;

(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.

53. There was mixed feedback from users on whether Alternative 1 or Alternative 2 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 net 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 50(a)–50(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.

54. 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.

Applying the fundamental qualitative characteristics

55. In assessing the usefulness of the financial information, the *Conceptual Framework* states that information must be relevant and faithfully represent what it purports to represent. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions.[20]

[20] Paragraphs 2.4–2.20 of the *Conceptual Framework.*

56. The staff does not think that Alternative 1 and Alternative 2 contradict each other because Alternative 2 is about applying the Standards in order—an investor would:

(a) as *Step 1*, apply the loss of control requirements in IFRS 10 (or IAS 16 by applying IFRS 15 guidance) by recognising full gains or losses and measuring any investment retained in the former subsidiary at fair value—that is, effectively, Alternative 1; and

(b) as *Step 2*, apply the requirement in IAS 28 by restricting gains or losses, see paragraphs 45–54 (and paragraphs B17–B24 of Appendix B) to Agenda Paper 13C for further discussion.

57. Alternative 2 describes the mechanics between IFRS 10 (or IAS 16) and IAS 28 without compromising the binary yes/no outcome set out in paragraph 46 of this paper which is the notion of Alternative 1. In other words, Step 2 is another aspect to the loss of control transaction—the relationship between an investor and its associate.

58. The question that we need to answer is: which of the alternatives (Alternative 1 or Alternative 2) provides the most useful financial information to primary users of financial statements.

Relevance

59. As discussed in paragraph 10(b) of this paper, IAS 28 requires an investor to restrict the gains or losses for transactions with its associate that constitute assets (for example, inventories under IAS 2 *Inventories* or PPE under IAS 16). Therefore, restricting (or not restricting) gains or losses for these transactions, in analysing the associate's performance, is relevant to investors applying IFRS Accounting Standards.

60. However, in identifying the information that would be most relevant, the question to address is whether:

(a) not restricting gains or losses for all type of transactions; or

(b) retaining and expanding the requirement to restrict gains or losses for other type of transactions, ie that constitute businesses,

would make a difference in the decisions to users.

61. The feedback from users set out in paragraphs 48–54 of this paper identifies that restricting gains or losses affects the equity method earnings quality and therefore users' decision-making. In particular, for those users who rely on the associate's earnings as reported in the investor's financial statements and do not appreciate similarities and differences in the amounts arising from these transactions. When estimating future cash flow to analyse the associate's performance, not restricting gains or losses would result in less disruptive earnings and, therefore, assist users in their valuation models.

Faithful representation

62. In determining whether information can provide a faithful representation of the economic phenomenon, the staff think that the conceptual reasons and feedback from users must be taken together in assessing whether restricting (or not restricting) gains or losses provides a faithful representation of the economic phenomenon.

63. Considering paragraphs 24–46 of this paper, the staff think that the objective of the elimination entries in IAS 28 becomes questionable because:

(a) a group is a parent and its subsidiaries. A group does not include associates therefore there is no conceptual basis to restrict the gains or losses.

(b) the rationale in IAS 28 for restricting gains or losses is consistent with:

(i) the parent-entity perspective; in contrast IFRS 3 and IFRS 10 are consistent with the reporting entity concept as included in the *Conceptual Framework*; and

(ii) the proportionate consolidation method, which was replaced in developing IFRS 11.

64. Considering users' feedback set out in paragraphs 48–54 of this paper, the staff observe that there is support for enhancing IAS 24 disclosure requirements to require an investor to disclose the amount of the gains or losses from transactions with its associate. Users supported enhancing such disclosure requirements in IAS 24 as this allows them flexibility to include or exclude such gains or losses in analysing an associate's performance.

65. The staff think that such feedback is in favour of Alternative 1 with enhanced disclosure. This is because retaining and expanding the elimination entries' requirement under Alternative 2, in isolation does not help the users and imposes costs on preparers (see practical reasons sub-section set out in paragraphs 78–90 of this paper).

66. The staff observe that:

    (a) those that expressed a preference for Alternative 2, apply a mixed approach to analysing equity method investments—the standalone performance of associates and equity method earnings quality.

    (b) Alternative 2 may impose additional costs for users to adjust restricted gains or losses through manual adjustments, particularly, as noted in paragraph 51(b) of this paper, the information disclosed for associates in the investor's financial statements is limited.

    (c) the feedback provides evidence that enhancing the disclosure requirements, to require an investor to disclose the amount of the gains or losses from transactions with its associate, would allow users to make their own assessment:

        (i) to decide how to factor in gains or losses in analysing an associate's performance; and

        (ii) with less disruptive earnings in future periods, see pages 6 and 9 to Agenda paper 4A of the Capital Markets Advisory Committee (CMAC) March 2023 meeting for further details.

(d) Alternative 1 with enhanced disclosure would provide users with the most useful information, limit users' additional costs in factoring in restricted gains or losses and reduce costs for the preparers.

(e) expanding the requirement to restrict gains or losses under Alternative 2 would lead to complications (allocating the restricted gains or losses if the transaction constitutes a business including tracking them in future periods) and the feedback did not provide evidence of whether the benefits to users would outweigh the cost of doing so.

67. The staff disagree with the argument that, on non-recurring transactions, without the requirement to restrict gains or losses, an investor can manage its earnings:

(a) feedback from preparers is that in the circumstance of significant influence transaction prices between an investor and its associate are negotiated on an arm's length basis.

(b) a possible solution to respond to this concern would be to require elimination entries when the transactions are not at fair value.

(c) however, the staff do not consider that (b) would be a viable option because it is an anti-avoidance measure. In addition, it may be challenging to identify whether the transaction is at fair value, and therefore the benefits of reporting this information are unlikely to justify the cost of providing the information.

(d) another possible solution could be to provide additional related party disclosures as set out in paragraph 52 of this paper, that is enhance IAS 24 disclosure requirements by requiring an investor to disclose the amount of the gains or losses from transactions between an investor and its associate.

(e) the staff note the IASB ruled out Alternative 3 as it could lead to unnecessary complexities in drawing lines between recurring and non-recurring transactions, see paragraphs 18–19 of this paper.

68. The staff observe that paragraph 7.6 of the *Conceptual Framework* states that effective communication in financial statements is also supported by considering a

principle that is duplication of information in different parts of the financial statements is usually unnecessary and can make financial statements less understandable. The feedback from some users as set out in paragraph 53(c) of this paper provides evidence that restricting gains or losses would restrict the information available to users—that is, the full gain or loss would not be disclosed.

69. Also, the staff think that, even if there are some concerns about earnings management, enhancing disclosure would address these concerns rather than retaining and expanding the requirement to restrict gains or losses, under Alternative 2.

70. In the staff's view Alternative 2, would:

(a) not help users in undertaking their analysis of investments in equity-accounted associates;

(b) impede comparability; and

(c) result in disruptive earnings.

71. Furthermore, in analysing an associate's performance, not restricting gains or losses for these transactions would result in equity method earnings faithfully representing the investor's share of the future economic benefits of equity-accounted associates, because restricting gains or losses is less important for users in doing their valuation models as it does not impact the cash flows.

72. The staff also think that Alternative 1 is consistent with the IASB's thinking when it issued the 2014 Amendment—that is, the most robust alternative (from a conceptual point of view) is to follow the rationale that underlies IFRS 3 and IFRS 10 for all sales and contributions (including the sale or contribution of assets that do not constitute a business), see paragraphs BC37G and BC190G of the Basis for Conclusions on the 2014 Amendment.[21]

[21] See 2014 Amendment for further details.

73. However, at that time, the IASB acknowledged that such thinking requires addressing multiple cross-cutting issues, including concerns, at that time, that the Interpretations Committee (Committee) would not be able to address on a timely basis. Cross-cutting concerns included:

(a) the definition of a 'group' in IAS 27 *Consolidated and Separate Financial Statements* and its implications on the measurement requirements of investments outside the group boundaries (such as associates); and

(b) the accounting for 'upstream' and 'downstream' transactions with entities outside the group boundaries (such as associates).

74. The staff note that the IASB recently completed the *Post-implementation Review of IFRS 10, IFRS 11 and IFRS 12* and concluded that the requirements of IFRS 10 are working as intended. In particular, the IASB concluded that IFRS 10 is meeting its objectives, and using the control model as the single basis for consolidation enables entities to determine whether they control another entity. The definition of a 'group' in IFRS 10 and its implications on the measurement requirements of investments not part of the group (such as associates) remains.

75. The staff also note that having expanded:

(a) the use of the acquisition method of accounting in IFRS 3, alongside articulating the reporting entity concept in the *Conceptual Framework*; and

(b) the 'loss of control' thinking in developing IFRS 15 and its amendments to paragraphs 68A, 69 and 72 of IAS 16, which require an entity to apply the guidance in IFRS 15 on determining when an entity transfers control of a non-monetary asset and how to measure the gains or losses upon derecognition (ie the full gains or losses recognition),

puts more pressure on the objective of the elimination entries in IAS 28.

Other conceptual considerations

76. At its April 2022 meeting, the IASB discussed the application question: *How does an investor apply the equity method when purchasing an additional interest in an associate while retaining significant influence*. The IASB asked the staff to proceed with an approach whereby an investor would measure the investment in the associate as an accumulation of purchases—so that, an investor would measure its additional share in the associate's net assets at fair value at the date of purchasing the additional interest (the preferred approach), see Agenda Paper 13A *Purchase of additional interest in an associate while retaining significant influence* of this meeting for further details.

77. The staff think that if Alternative 2 is taken forward, tension could arise in applying the preferred approach alongside restricting gains or losses in some fact patterns. This is because restricting gains or losses may push an investor's additional interest purchased below the fair value of its additional share in the associate's net assets. For example, an investor, that has 20% of an associate, contributes a non-monetary asset to its associate in exchange for an additional 5% in the associate, see paragraphs 65–67 of Agenda Paper 13C to the September 2022 IASB meeting for further details.

Practical reasons

78. The staff have considered the practical reasons for Alternative 1 and Alternative 2. In doing so, the staff have considered:

(a) practicability and costs attached to gathering information required for the equity method of accounting at the date of the transaction and in future periods; and

(b) costs attached to allocating or tracking the restricted gains or losses, particularly if a transaction constitutes a business.[22]

[22] Paragraph 7 of IAS 1 *Presentation of Financial Statements* (and paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) states that impracticable means applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

Feedback from GPF, accounting firms and ASAF

79. Feedback from preparers was that for associates:

(a) sometimes they have difficulty in obtaining information required for the equity method of accounting, for example when gains or losses are restricted on downstream transactions whether (and when) the asset has been sold by the associate to a third party.

(b) these difficulties can be compounded in a transaction that is a contribution of a business in which the transaction has assets and goodwill acquired and liabilities assumed.

80. The following sets out the practical reasons, as part of the feedback from GPF, accounting firms and ASAF, for supporting/opposing Alternative 1 and Alternative 2.[23]

Supporters of Alternative 1 *(No elimination)*[24]	Supporters of Alternative 2 *(Elimination)*
— It would be the simplest alternative to apply and audit. — It would avoid gathering information required for elimination entries; an investor often receives minimal cooperation from its associates. — It would not introduce new complexities or judgements.	— It would result in the least significant change to practice.
Opponents of Alternative 1 *(No elimination)*	**Opponents of Alternative 2 *(Elimination)***
— It would require a change to IAS 28.	— It would increase the cost and complexity of applying the equity method. — It may be difficult to gather information required, particularly if the transaction is a business.

[23] See paragraphs 7–18 of Agenda Paper 13B to the January 2023 IASB meeting for further details.

[24] Some accounting firms said also that Alternative 1 resolves other related application questions in the project—ie it is resource efficient for the IASB and its stakeholders.

Alternative 1

81. If Alternative 1 is taken forward, there would be as a change in the equity method procedures. However, in the staff's view, Alternative 1 would itself be a simplification in the equity method procedures. Alternative 1 would:

    (a) significantly simplify the effort needed and costs of applying the equity method procedures, an investor would no longer be required to:

        (i) gather information required for elimination entries;

        (ii) exercise judgement to allocate the restricted gains or losses; or

        (iii) track whether (and when) an associate has sold the asset to a third party.

    (b) remove the diversity that has emerged in practice, see paragraph 13 of this paper.

    (c) enhance comparability and provide better-quality information to the users.

82. The staff think that:

    (a) if Alternative 1 is taken forward with enhanced disclosure, it would be less costly to apply than Alternative 2.

    (b) Alternative 1 with enhanced disclosure would provide information comparable to Alternative 2 but:

        (i) be somewhat more precise, see paragraphs 51–53 of this paper; and

        (ii) without the need for future tracking of the restricted gain or loss, it would reduce costs to preparers.

83. Agenda paper 4A of the CMAC March 2023 meeting demonstrates how restricting gains or losses affects an investors' financial statements by illustrating two examples as set out in Appendix A of that paper:

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

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

Alternative 2

84. The staff acknowledge that, in theory, retaining and expanding the elimination entries' requirement would result in the least significant change to practice. However, the staff think this needs to be considered alongside the feedback from preparers about practical challenges, including:

 (a) allocating the restricted gains or losses if the transaction constitutes a business; and

 (b) tracking the restricted gains or losses in future periods.

85. The feedback did not identify how to overcome the challenges set out in paragraph 84 of this paper, which could:

 (a) require significant judgement; and

 (b) impose costs and introduce unnecessary complexity to investors, while there is doubt whether these costs would be outweighed by the benefits.

86. At its January 2023 meeting, some IASB members expressed sympathy with the feedback from GPF members about the practical challenges of obtaining information and suggested proceeding with the 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.

87. Another IASB member expressed the concerns set out in paragraph 86 of this paper; although he expressed support for Alternative 2. He noted that, in practice, investors restrict gains or losses only at the transaction date and do not track them in future periods.

88. For example, on a downstream transaction:

 (a) an investor sells an item of equipment to its associate and recognises in its financial statements a disposal gain of CU100.

(b) assuming the investor owns 20 per cent of the associate, the investor would restrict that gain to CU80.

(c) the investor recognises that part of the gain, that has been restricted (ie CU20), in future periods, either when the equipment is sold to a third party or over the useful life of the equipment.

89. In the staff's view, Alternative 2 may increase complexity if:

(a) the transaction constitutes a business because tracking is required for assets and liabilities.

(b) the transaction is an upstream transaction because the investor may not be able to obtain sufficient information about how much of the gain is at the transaction date.

90. The staff, therefore, think that Alternative 2:

(a) could compound the inconsistency of how paragraph 28 of IAS 28 is applied;

(b) might not provide a faithful representation of the economics of the transaction; and

(c) could increase complexity in practice.

Cost-benefit considerations (Effects analysis)

91. The IASB is committed to assessing and explaining its views on the likely costs of implementing proposed new requirements and the likely ongoing associated costs and benefits of each new IFRS Accounting Standard—the costs and benefits are collectively referred to as effects. In assessing the likely effects, the IASB considers several issues, for example the IASB focuses on assessing how financial statements are likely to change because of the new financial reporting requirements, whether those changes will improve the quality of financial statements and whether those changes are justifiable.

92. Paragraphs 2.39–2.43 of the *Conceptual Framework* state the guidance on the cost constraint on useful financial reporting. In applying the cost constraint, the IASB assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information.

93. As noted in paragraphs 78–90 of this paper and the feedback from preparers, users, auditors and national standard-setters, Alternative 1 is cost effective compared to Alternative 2. This is because:

    (a) if Alternative 1 with enhanced disclosure is taken forward, it decreases costs (including collecting, processing and verifying financial information). At the same time, it maximises the benefits that users receive; whereas

    (b) if Alternative 2 is taken forward, it imposes costs and requires significant judgements and complexities, particularly because the restricted gains or losses at the transaction date should be recognised in future periods when the asset is sold to a third party or over the useful life of the asset. At the same time, it minimises users' benefits and requires them to incur additional costs, as set out in paragraphs 51(b) and 66(b) of this paper.

94. The tables below set out the costs and benefits of Alternative 1 with enhanced disclosure and Alternative 2.

    (a) how the proposed changes are likely to affect the financial statements;

Alternative 1 (*No elimination*) with enhanced disclosure	Alternative 2 *(Elimination)*
— It would result in less disruptive accounting over the life cycle of the asset that has been transferred. — It would require disclosing additional information about the amount of the gains or losses arising from these transactions.	— For the transactions that constitute a business, it would result in: (a) a lower carrying amount of an investment in an associate in earlier years; and (b) a lower profit in earlier years, but a higher profit over the later years.
There is no change to the cash flow statement.	

(b) how those proposed changes are likely to affect the comparability of financial information between different reporting periods for an individual entity and between different entities in a particular reporting period;

Alternative 1 (*No elimination*) with enhanced disclosure	Alternative 2 *(Elimination)*
— It would remove diversity in practice and provide less disruptive earnings and, therefore, enhance comparability between different reporting periods for an investor and between different investors in a particular reporting period. — It would improve information provided to users for evaluating equity-accounted investments, which improves users' ability to compare and contrast.	— It would possibly expand restricting gains or losses to transactions that constitute a business; so, maintaining comparability depends on whether investors can gather the information needed and track the transactions in future periods. — It might impede comparability as it requires significant judgement and potentially facilitates more diversity in practice.

(c) how the proposed changes are likely to affect the ability of a user of financial statements to assess the future cash flows of an entity and the likely effects on the costs of analysis for users of financial statements; and

Alternative 1 (*No elimination*) with enhanced disclosure	Alternative 2 *(Elimination)*
— As noted in paragraphs 52–53 of this paper, information applying Alternative 1 would be more concise and easier to understand. — It would allow users the flexibility to value such gains or losses in analysing the associate's performance. — The staff do not consider that there would be any significant additional costs to users.	— As noted in paragraph 66 of this paper, users might incur additional costs in factoring in restricting gains or losses manually. — The feedback from some users as set out in paragraph 53(c) of this paper provided evidence that restricting gains or losses in isolation would not provide information on the full amount of gain or loss.

(d) the likely effect on compliance costs for preparers, both on initial application and ongoing.

Alternative 1 (*No elimination*) with enhanced disclosure	Alternative 2 *(Elimination)*
— Preparers would no longer be required to: (a) reduce their share of gains or losses resulting from transactions in proportion to their ownership share in the associate at the date of the transaction; or (b) track in future periods whether an asset is sold to a third party or amortise the restricted gains or losses over the asset's useful life. — Preparers would need to provide information about the full gains or losses for the disclosures, at the transaction date. The staff do not think that costs of collating information for compliance with the disclosures would be significant because they are already required to obtain this information to apply paragraph 28 of IAS 28.	— Preparers would incur costs to gather information required for restricting gains or losses at the transaction date and ongoing tracking would be required. — Preparers would also incur costs of adjusting systems/software developed to comply with the requirements to restrict gains or losses for the transactions that constitute businesses. As part of that, the staff also think that it requires judgement on how to allocate (or proportion) the gains or losses if the transaction constitutes a business.

Question to the IASB

Question to the IASB
1. Does the IASB agree with the staff recommendation in paragraph 7 of this paper to propose amendments to IAS 28 and IAS 24 to require an investor to recognise the full gain or loss on all transactions with its associate and disclose that gain or loss, respectively (collectively referred as Alternative 1 with enhanced disclosure)?