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Staff paper

Agenda reference: 6A

Accounting Standards Advisory Forum meeting

Date	**8 – 9 December 2022**
Project	**Equity Method**
Topic	**Transactions between an investor and its associate–an acknowledged inconsistency between the requirements of IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures***
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This paper has been prepared for discussion at a public meeting of the Accounting Standards Advisory Forum (ASAF). This paper does not represent the views of the International Accounting Standards Board (IASB) or any individual IASB member. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS® Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB *Update*.

Purpose of this session

- To ask ASAF members for views on *four* alternatives identified to answer the application question:

How should an investor recognise gains and losses that arise from the sale of a subsidiary to its associate applying the requirements of IFRS 10 and IAS 28?

This application question relates to an acknowledged inconsistency between the requirements of IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures* (this slide deck and Agenda Paper 6B of this meeting).

Questions for ASAF members

Q1. What are your views on the *four* alternatives set out in slides 10–14? Please explain the rationale for your view.

Q2. Which alternative, do you think, provides a faithful representation of the transaction set out in the application question? Please explain why.

Agenda Paper 6B of this meeting represents Agenda Paper 13C of the IASB's September 2022 meeting. It explains the history of the inconsistency, the amendment issued in 2014 and the four alternatives, including the staff analysis of their advantages and disadvantages.*

* For further details of the IASB's discussion at its September 2022 meeting, refer to IFRS - IFRS webcast.

Agenda

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Introducing the application question

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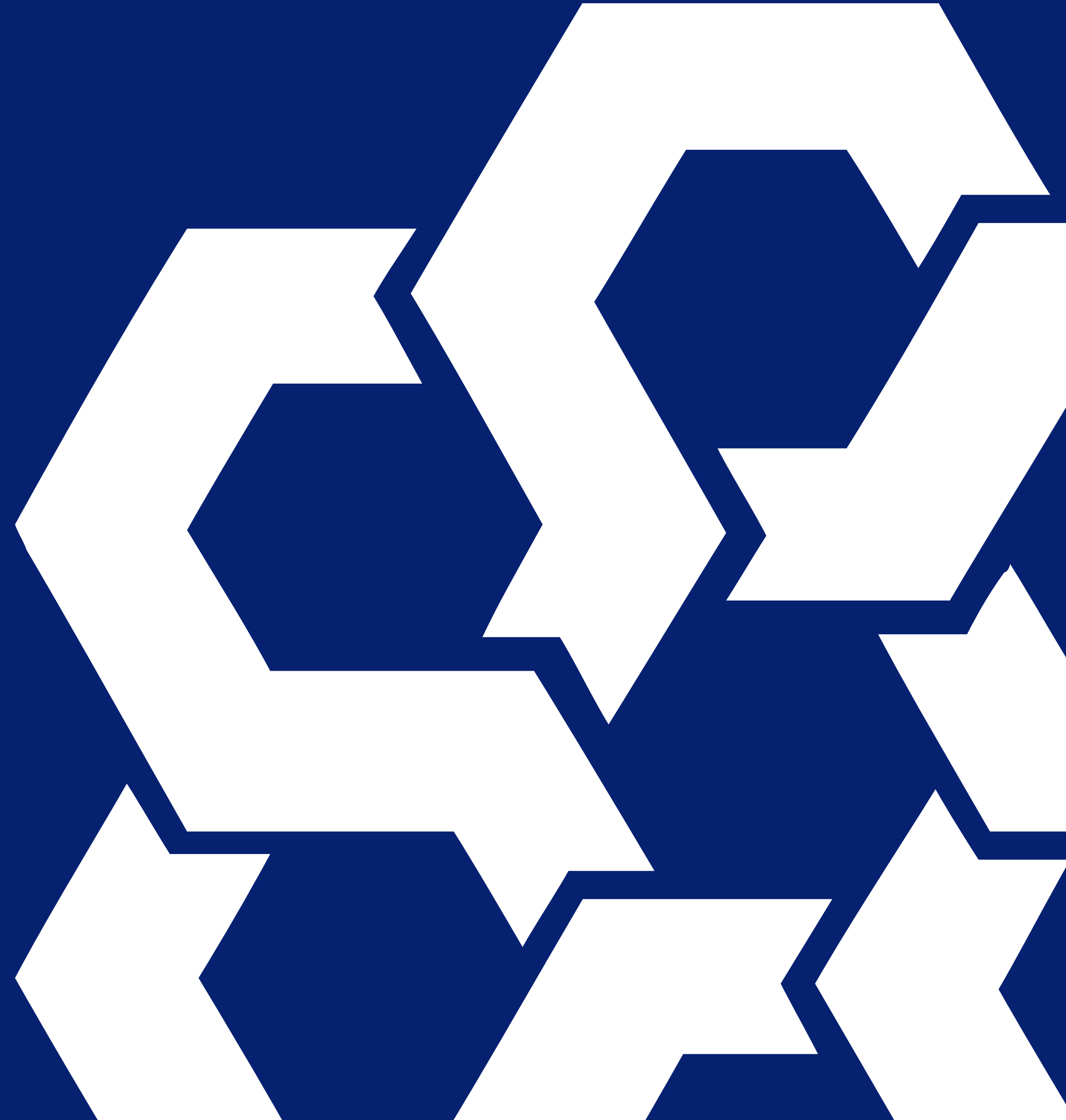
Background on the Equity Method project



Background on the Equity Method project*

- The objective of the Equity Method project is to assess whether application questions on the equity method, as set out in IAS 28, can be addressed in consolidated and individual financial statements by identifying and explaining the principles of IAS 28.

The project approach has three steps:

- identify the application questions to be addressed using agreed selection criteria;
- identify and explain principles that underlie IAS 28; and
- use the principles to develop solutions to the application questions.

* For more details about the project, please refer to the project page on the IFRS website

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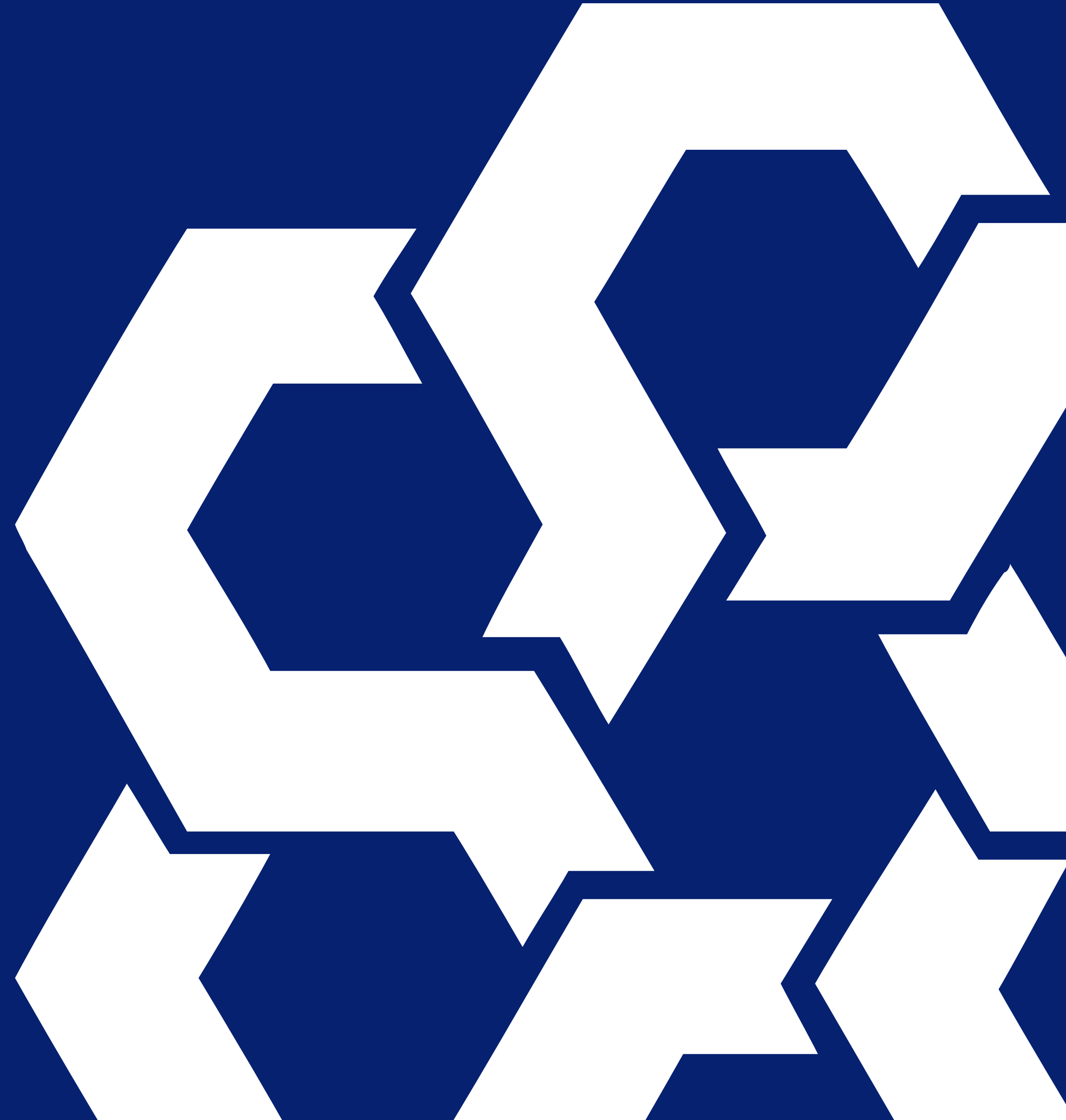
Introducing the application question



Introducing the application question

How should an investor recognise gains and losses that arise on the sale of a subsidiary to its associate applying the requirements of IFRS 10 and IAS 28?

To answer the application question, at its September 2022 meeting the IASB started to explore *four* alternatives.

The IASB asked the staff to continue exploring the *four* alternatives and bring a decision-making paper to a future meeting.

The application question arises because:

- paragraphs 25 and B97–B99 of IFRS 10 require an investor to *recognise* in *full* the gain or loss on the loss of control of a subsidiary, remeasuring any retained interest at fair value; whereas
- paragraphs 28 and 30 of IAS 28 require an investor to *restrict* the gain or loss recognised to the extent of the unrelated investors' interests in an associate, that is an investor eliminates the gain on its related interest.

In 2014 the IASB issued amendments to IFRS 10 and IAS 28, these amendments were later indefinitely deferred and are not yet effective.

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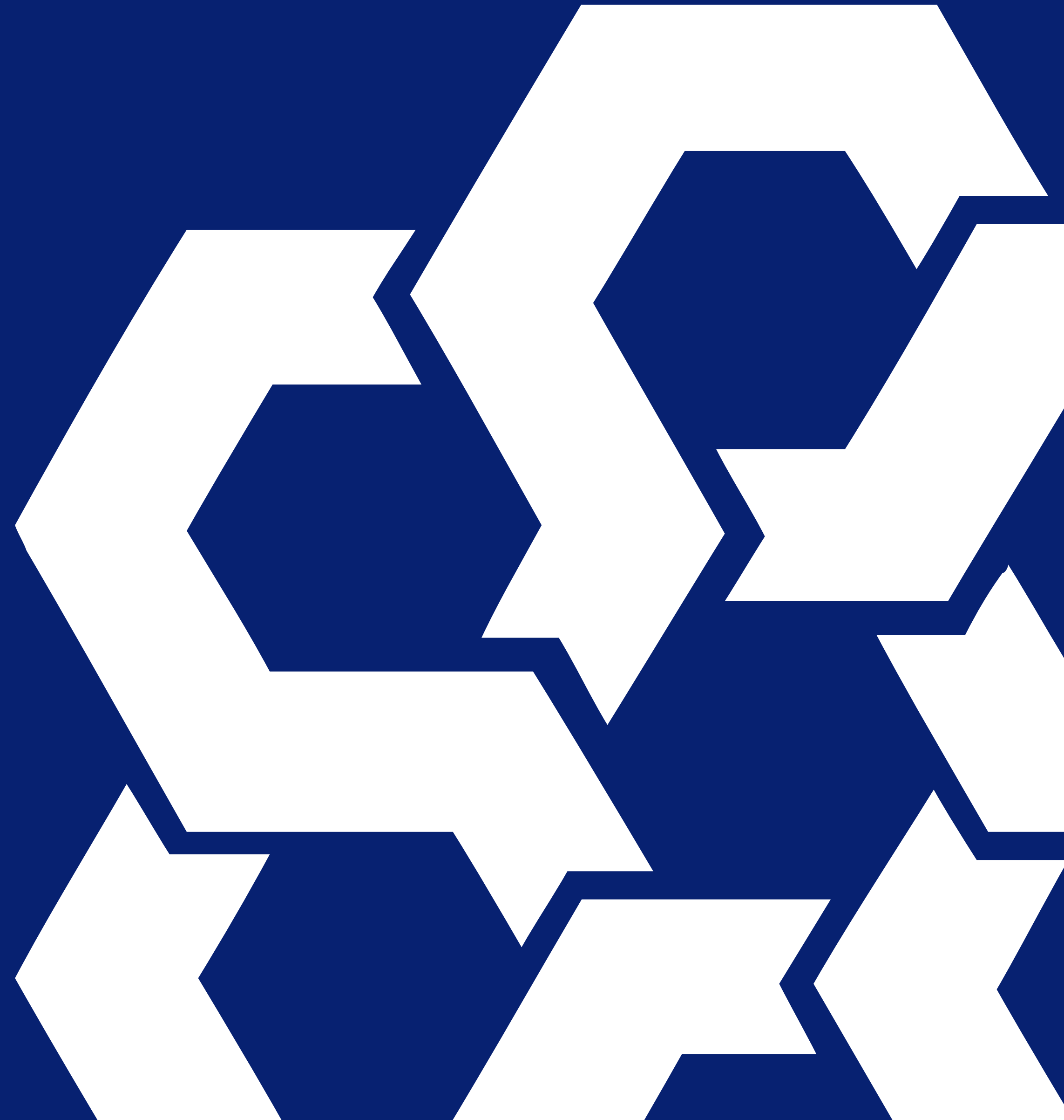
Summary of the *four* alternatives



Summary of the *four* alternatives

<table>
<tr><td rowspan="2">Recognition of full gain or loss <u>versus</u> partial gain or loss</td><td colspan="2">Sale/contribution of a <u>business</u> that is</td><td colspan="3">Sale/contribution of an <u>asset</u> that is</td></tr>
<tr><td><u>housed</u> in a subsidiary</td><td><u>not housed</u> in a subsidiary</td><td><u>housed</u> in a subsidiary</td><td colspan="2"><u>not housed</u> in a subsidiary</td></tr>
<tr><td>Alternative 1
(Non-elimination)</td><td>Full</td><td>Full</td><td>Full</td><td colspan="2">Full</td></tr>
<tr><td>Alternative 2
(Elimination)</td><td>Partial</td><td>Partial</td><td>Partial</td><td colspan="2">Partial</td></tr>
<tr><td rowspan="2">Alternative 3
(Mixture)</td><td rowspan="2">Full</td><td rowspan="2">Full</td><td rowspan="2">Full</td><td>Ordinary activities</td><td><u>Not</u> ordinary activities</td></tr>
<tr><td>Partial</td><td>Full</td></tr>
<tr><td>Alternative 4
(Reviving 2014 Amendment)</td><td>Full</td><td>Full</td><td>Partial</td><td colspan="2">Partial</td></tr>
<tr><td>Current practice approach(es)</td><td>Policy choice (full/partial)</td><td>Unclear</td><td>Many towards policy choice (full/partial)</td><td colspan="2">Partial</td></tr>
</table>

* For further details, refer to paragraphs 33–69 of Agenda Paper 6B to this meeting and, also, Appendix B of that paper for which sets out other conceptual matters relevant to the staff's analysis in this paper. For further details of the IASB's discussion at its September 2022 meeting, refer to IFRS - IFRS webcast.

Summary of Alternative 1

Alternative 1

Recognise the *full* gain on all contributions and sales of assets or businesses, regardless of whether they are housed in a subsidiary or not.

No elimination entry requirements apply.

Rationale

Alternative 1 is consistent with an alternative the IASB considered when developing the 2014 Amendment—this alternative follows the concepts that underlie IFRS 3 *Business Combinations* and IFRS 10 for all sales and contributions.

Recognition of the *full* gain is justified because the nature of the asset has changed in all contributions and sales.

Arguments supporting this alternative include: a group (as defined) does not include associates therefore the role of the elimination entries in IAS 28 becomes questionable.

Advantages:

- Removing the elimination requirements would remove the demonstrated diversity in practice.
- Sometimes it is difficult to obtain information required for elimination entries.

Disadvantages:

- Not requiring elimination entries is a change to the equity method as set out in IAS 28, which refers to consolidation procedures.

Summary of Alternative 2

Alternative 2

Recognise a partial gain on all contributions and sales of assets or businesses, regardless of whether they are housed or not in a subsidiary.

Rationale

The requirements of IFRS 10 and IAS 28 are both applied to the transaction as an overlay approach*.

Alternative 2 is consistent with paragraph 30 of IAS 28, when an entity applies the derecognition requirements in IAS 16 and then overlays with the elimination requirements in IAS 28.

No reason identified for why the requirements for derecognition of an asset should be different from those for derecognition of a business.

Advantages:
- Prescribes how to apply IFRS 10 and IAS 28 without compromising the IASB's rationale that underlies the Business Combination or the Consolidations projects.

Disadvantages:
- In practice obtaining information required for elimination entries, particularly in a contribution that constitutes a business, can be challenging.

* An overlay approach is just about the general mechanics of how the Standards interact with each other. Alternative 2 does not result in an entity no longer complying with the loss of control requirements in IFRS 10 but that there is another aspect to the loss of control transaction—a new relationship between an investor and its associate. For further explanation of those two steps, refer to paragraphs B17–B24 of Appendix B of Agenda Paper 6B to this meeting.

Summary of Alternative 3

Alternative 3

Recognise the *full* gain on transactions *out* of the scope of IFRS 15.

Recognise a *partial* gain on transactions *in* the scope of IFRS 15 (even if it is housed in a subsidiary).

Rationale

Partial elimination depends on the nature of the transaction between the investor and its associate—whether the counterparty is a 'customer' in accordance with IFRS 15 *Revenue from Contracts with Customers*.

Assumes users *disregard or value* gains or losses differently on transactions that are *not* in the scope of IFRS 15 because those transactions are non-recurring. The full gain or loss would be recognised for these transactions.

Eliminates differences between transactions involving derecognition of assets and transactions involving derecognition of businesses.

Advantages:

- Middle-ground alternative (ie less disruptive to existing practices).
- Limits the tensions under Alternative 1.

Disadvantages:

- It would apply different requirements to sales in scope of IFRS 15 than to sales not in scope of IFRS 15.

Summary of Alternative 4

Alternative 4

Revive the 2014 Amendment.

Recognise the *full* gain when a transaction involves a business.

Recognise a *partial* gain when a transaction involves an asset.

Rationale

IFRS 10 requirements came from the Business Combinations project; apply these requirements to transactions that involve a business.

Retain the requirements for groups of assets that do not constitute a business; these transactions were outside the scope of the Business Combinations project.

Advantages:

- It is resource efficient for both the IASB and its stakeholders, as only the 2014 Amendment would be amended to address a conflict that arises with paragraph 32 of IAS 28.

Disadvantages:

- Complexity is introduced as there would be different derecognition requirements between loss of control of a business and disposing of an asset.

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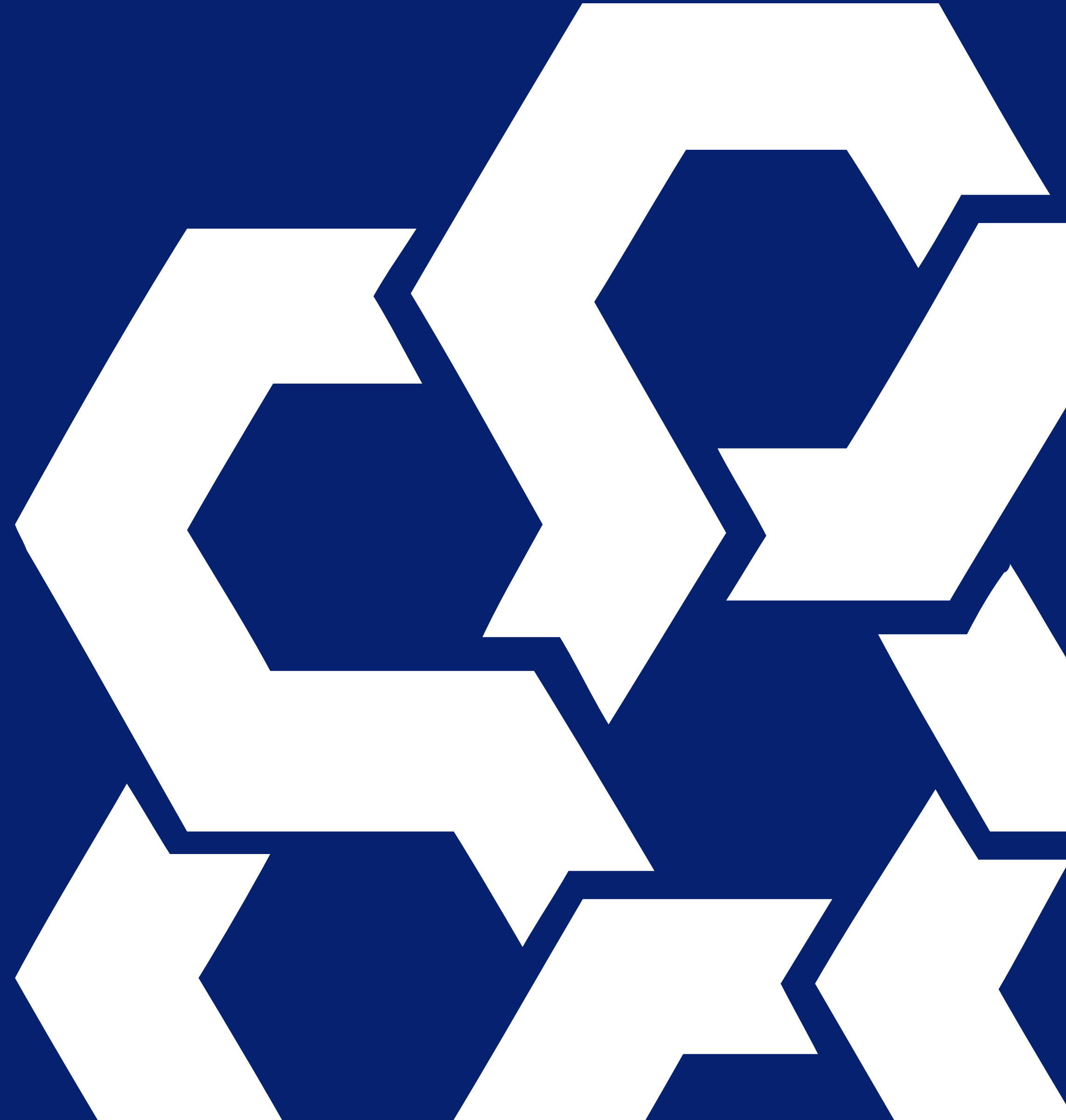
Informal feedback from accounting firms



Summary of feedback

Outreach	Following the September 2022 IASB meeting the IASB technical staff have asked the accounting firms for *informal* feedback on the four alternatives.

Key Messages

Diversity in practice exists for this application question.

Support for either:

- Alternative 1; or
- Alternative 2.

Suggests to proceed with an alternative that:

- is simple to apply; and
- does not introduce new complexities or judgements.

Key points raised

Alternative 1	**Support:** • 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’. **Challenges:** • Is a fundamental change to the equity method procedures in IAS 28.
Alternative 2	**Support:** • Result in the least significant change to practice—it does not introduce new concepts or judgements. **Challenges:** • 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.

Key points raised

Alternative 3	**Support:** • Could remove structuring opportunities for those transactions in the scope of IFRS 15. **Challenges:** • Need to justify the different requirements for sales to customers and those that are not? The distinction results in the different measurement of gain and loss. • Requires additional processes to monitor and classify transactions.
Alternative 4	**Support:** • Recognises requirements for sale of a business are different from those for sale of an asset. **Challenges:** • Need to justify the distinction between the sale of an asset and of a business? The distinction results in the different measurement of gain and loss. • Requires additional processes to monitor and classify transactions.

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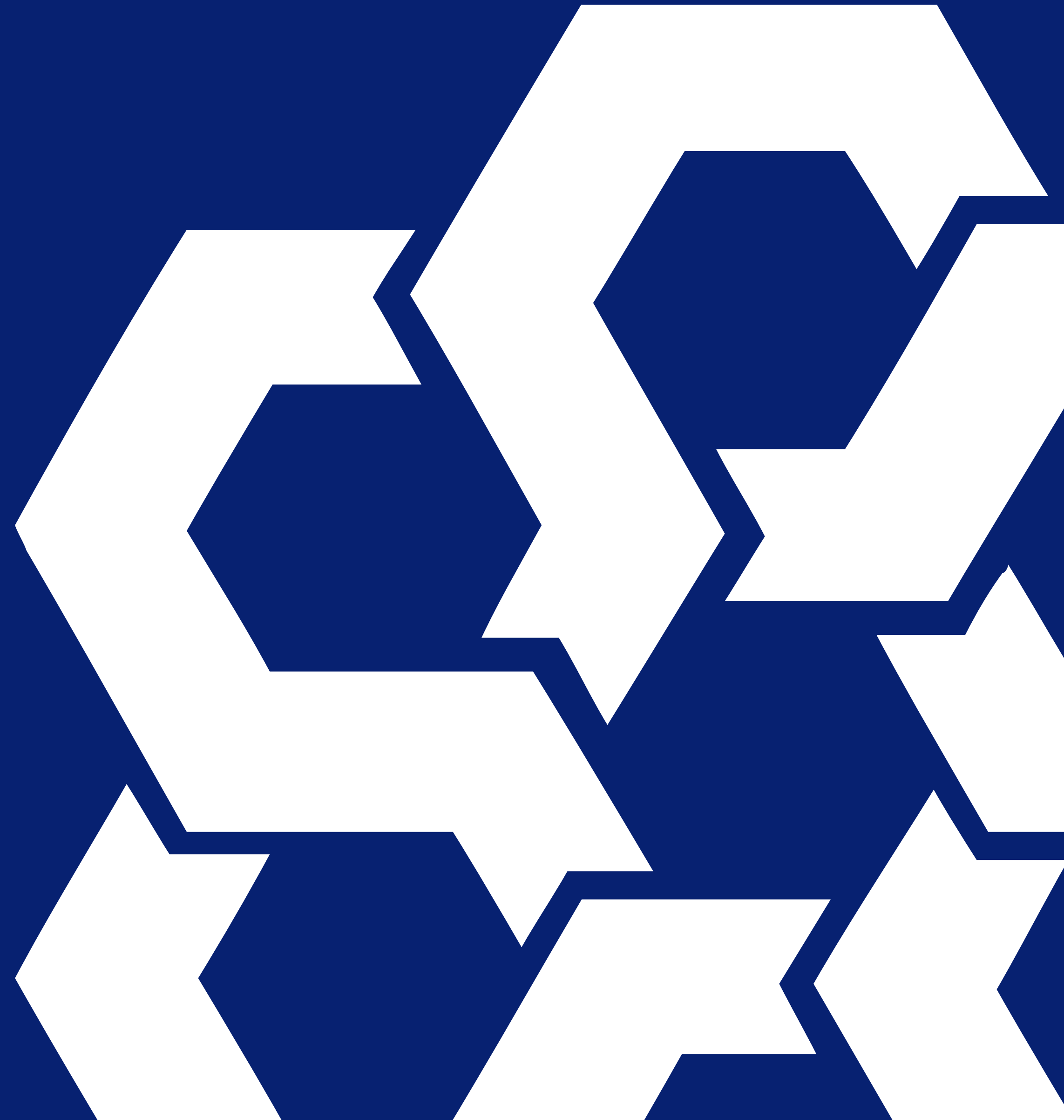
Questions for ASAF members



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Thank you

For more details about the project, please refer to the project page on the IFRS website

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