Accounting Standards Board of Japan
Financial Accounting Standards Foundation

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### Equity Method of Accounting

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# Perspectives on the Equity Method of Accounting

Accounting Standards Board of Japan

## Introduction

1. The question of whether the equity method of accounting should be viewed as one-line consolidation or a measurement basis[1] has been a long-standing question. Because the International Accounting Standards Board (IASB) has not directly addressed this question, diversity exists under IFRS Standards in practice and questions continue to be submitted to the IFRS Interpretations Committee.

2. This paper proposes principles that would clarify when to focus on the aspect of one-line consolidation and when to focus on the aspect of a measurement basis to address the current practical issues arising from applying the equity method of accounting, with the understanding that the existing requirements in IAS 28 *Investments in Associates and Joint Ventures* have both aspects of one-line consolidation and a measurement basis. Constituents in our jurisdiction note that the equity method of accounting provides useful information but there are practical issues that cannot be resolved under existing guidance. Accordingly, this paper is not intended to discuss whether the equity method of accounting should be viewed as one-line consolidation or a measurement basis, but rather to propose principles that would address the current practical issues. Some of the existing requirements in IAS 28 would need to be amended to incorporate the principles we propose.

3. This paper is structured as follows:

   Part A: The Three Main Approaches

   In Part A, we describe and present our views on the three main approaches regarding the equity method of accounting: (1) one-line consolidation, (2) a measurement basis and (3) a hybrid of the two approaches.

   Part B: Our Proposed Principles in Applying the Hybrid Approach

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[1] The term 'measurement basis' used in this paper does not refer to that term as defined in paragraph 6.1 of the IASB's *Conceptual Framework for Financial Reporting* but refers to that term as used by European Financial Reporting Advisory Group (EFRAG) in EFRAG Short Discussion Series *The Equity Method: A Measurement Basis or One-Line Consolidation?* issued in 2014. Paragraph 29 of the EFRAG paper describes this view as "the equity method is about measurement of an asset rather than being a one-line consolidation".

Concluding that the equity method of accounting should be viewed as a hybrid of the two approaches in Part A, in Part B, we propose principles that could be applied to the hybrid approach.

Part C: Accounting for Consolidations

In Parts A and B of this paper, we present our views based on the requirements in current IFRS Standards related to the accounting for consolidations. However, in Part C, we present our views on the current requirements related to the accounting for consolidations.

4. This paper focuses on improving how the equity method of accounting is currently applied. This paper does not discuss the appropriateness of the scope of entities to which the equity method of accounting should apply. We do not discuss whether the equity method should be applied to both associates and joint ventures; nor do we discuss the definitions of significant influence and joint control. In other words, this paper takes the scope of entities that are to apply the equity method of accounting as currently required in IFRS Standards. We believe this is consistent with the IASB's current approach to the Equity Method project. In addition, this paper ignores the requirements in IAS 28 related to a venture capital or a similar organisation.

5. This paper refers to diversity in practice. In observing the existence of diversity in practice, we referred to the guidance provided by large accounting firms.

## PART A: The Three Main Approaches

### *Overview*

6. Part A discusses whether the equity method of accounting should be viewed as one-line consolidation, a measurement basis or a hybrid of the two approaches.

### *The Equity Method of Accounting as One-Line Consolidation*

7. If the equity method of accounting were to be viewed as one-line consolidation, applying the equity method of accounting to an associate or joint venture should have the exact same effect on total net assets and profit or loss as if the associate or joint venture were consolidated. In other words, the difference between consolidations and the equity method of accounting can be viewed as a matter of presentation, where consolidated entities would present their assets, liabilities, income and expenses on a gross basis, and entities accounted for under the equity method of accounting would present their assets, liabilities, income and expenses on a net basis.

8. The current requirements under IAS 28 are inconsistent with this view in its purest form. Under consolidations, the parent would absorb losses beyond the carrying value of the investment for its share in the subsidiary[2]. However, under IAS 28, the investor would not recognise losses in excess of the carrying value of the investment unless the investor has legal or constructive obligations to absorb the losses.

### *The Equity Method as a Measurement Basis*

9. If the equity method of accounting were to be viewed as a measurement basis, the unit of account would be the investment itself, that is, the entire carrying amount of the net investment would be accounted for as a single asset[3]. The asset may be impaired and written down to zero, but the investor would not recognise any further losses unless the investor has obligations to absorb such losses.

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[2] If non-controlling shareholders exist, those non-controlling shareholders absorb the losses for their share in the subsidiary.

[3] We use the term 'single asset' in this paper to indicate that the equity method of accounting is applied with an asset representing the share of the net assets of the associate or jointly venture as a unit. We acknowledge the following:

- an interest in the associate or joint venture may comprise more than one type of equity instruments and potential voting rights may be taken into account.
- long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture are taken into account in determining the amounts to recognise losses of an associate or joint venture; however, the financial instruments are accounted for in accordance with IFRS 9 *Financial Instruments.*

10. The current accounting requirements in IAS 28 are inconsistent with this view in its purest form. 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 *Consolidated Financial Statements*, and a typical example would be the elimination of unrealised profits or losses from upstream and downstream transactions. If the investment were to be viewed as a single asset, the elimination of such profits or losses would not be required.

***The Equity Method as a Hybrid of the Two Approaches***

11. The previous paragraphs illustrate how the two views, in their purest forms, are inconsistent with the current requirements in IAS 28. The question is whether IAS 28 should be amended so that the accounting would be consistent with one of the two approaches mentioned above, or whether IASB should accept the fact that the equity method of accounting is neither of the two views in their purest forms but a hybrid of the two approaches.

12. We believe that the equity method of accounting is neither of these two approaches in their purest forms but a hybrid of the two approaches. Moreover, within the hybrid approach, we believe that the equity method of accounting is based on one-line consolidation, with a few exceptions. Our reasons include the following:

    (a) Neither significant influence nor joint control constitutes control of an investee. Accordingly, requiring the equity method of accounting to have the same effect on total net assets and profit or loss as if the investor controlled the investee may not result in a faithful representation of the investment.

    (b) However, significant influence or joint control is not obtained by accident. Management makes deliberate decisions to obtain significant influence or joint control, taking into account the accounting that will follow. While significant influence or joint control does not constitute control of an investee, associates and joint ventures accounted for using the equity method of accounting are closer to the investor compared to investments accounted for in accordance with IFRS 9 and thus warrant accounting that is closer to consolidation.

13. We also note that EFRAG paper noted that the equity method of accounting has features of both a consolidation approach and a measurement basis[4].

14. In our view, when adopting a hybrid approach (and thus the current requirements in IAS 28) it is necessary to clarify when to place more emphasis on one approach over the other and why. We believe that the equity method of accounting should be consistent with one-line consolidation subject to a few exceptions for the reason set out in paragraph 12 (b) of this paper. Part B discusses our view on how to apply the hybrid approach.

## Part B: Our Proposed Principles in Applying the Hybrid Approach

### *Overview*

15. Concluding that the equity method of accounting should be viewed as a hybrid of the two approaches in Part A of this paper, in Part B, we propose principles that could be applied to the hybrid approach. In summary, we propose the following principles:

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| **Principle 1**: | The unit of account for the interest[5] in an associate or a joint venture is the interest itself (that is, an investment in a single asset), rather than the assets and liabilities of the associate or joint venture. The investor shall recognise an asset representing its share of the net assets of the associate or joint venture, and income or expense representing its share of the net profit or loss of the associate or joint venture. |
| **Principle 2**: | Impairment of the interest in the associate or joint venture shall be tested against that interest in its entirety. The carrying amount of |

[4] See footnote 1.

[5] We acknowledge that an interest in the associate or joint venture may comprise more than one type of equity instruments. However, for simplicity, this paper uses the singular form and refers to a single asset.

the interest may be written down to zero, and no additional liabilities would be recognised unless:

(a) the investor has legal or constructive obligations to absorb the losses; or

(b) the amounts that would otherwise be eliminated (in the case of gains from downstream transactions or dividends) exceed the carrying amount of the interest.

**Principle 3**: Neither significant influence nor joint control constitutes control of an investee. Accordingly, the accounting requirements related to consolidations for the investor's ownership interests based on the concept of a group (a parent and its subsidiaries) shall not be carried over to the accounting requirements related to the equity method.

**Principle 4:** For issues that are not covered by Principles 1 to 3, the accounting requirements related to the equity method shall follow the accounting requirements related to consolidations.

16. The following paragraphs discuss each Principle in detail.

***Principle 1***

**Principle 1**: The unit of account for the interest in an associate or a joint venture is the interest itself (that is, an investment in a single asset), rather than the assets and liabilities of the associate or joint venture. The investor shall recognise an asset representing its share of the net assets of the associate or joint venture, and income or expense representing its share of the net profit or loss of the associate or joint venture.

*Rationale for this Principle*

17. Neither significant influence nor joint control constitutes control of an investee. Accordingly, unlike consolidation, it would be inappropriate to recognise the full amount of the individual assets and liabilities of the associate or joint venture.

18. Proportionate consolidation may be one alternative; however, it is questionable whether it is appropriate for the investor to recognise its proportionate share of the assets and liabilities of the associate or joint venture that it does not control. On the other hand, it is clear that the investor controls an interest in the associate or joint venture. Accordingly, such interest in an associate or joint venture should be recognised as an asset of the investor.

19. The asset that the investor recognises represents the investor's share of the net assets of the associate or joint venture, and the related income or expense that the investor recognises represents the investor's share of the net profit or loss of the associate or joint venture. Accordingly, the gains or losses that would be eliminated from upstream and downstream transactions would be the investor's share of the gains or losses.

*Implications of this Principle*

20. The implications of Principle 1 can be summarised as follows:

    (a) The interest in the associate or joint venture would be recognised as a single asset; the assets and liabilities of the associate or joint venture would not directly be recognised by the investor. The recognised asset represents the investor's share of the net assets of the associate or joint venture.

    (b) The income or expense from the investment represents the investor's share of the net profit or loss of the associate or joint venture. Gains or losses that would be eliminated from upstream and downstream transactions would be the investor's share of such gains or losses.

*Potential Changes to IFRS Standards*

21. The implications of Principle 1 are fairly consistent with the current requirements in IAS 28.

*Principle 2*

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| **Principle 2**: | Impairment of the interest in the associate or joint venture shall be tested against that interest in its entirety. The carrying amount of the interest may be written down to zero, and no additional liabilities would be recognised unless:<br>(a) the investor has legal or constructive obligations to absorb the losses; or<br>(b) the amounts that would otherwise be eliminated (in the case of gains from downstream transactions or dividends) exceed the carrying amount of the interest. |

*Rationale for this Principle*

22. Following Principle 1, the interest in the associate or joint venture will be accounted for as a single asset. It follows that impairment would be tested against the entire carrying amount of the net investment as a single asset. (We assume that the impairment test would be conducted in accordance with IAS 36 *Impairment of Assets*[6].) In addition, the losses the investor absorbs will be limited to the amount invested unless the investor has legal or constructive obligations to absorb further losses. We note this is one of the main differences between consolidation and the equity method of accounting.

23. In some cases, the amounts that would otherwise be eliminated may exceed the carrying amount of the interest in the associate or joint venture. Examples of such amounts include:

(a) unrealised gains from downstream transactions; and

(b) dividends.

[6] IAS 28 requires that IFRS 9 be applied to financial instruments that are long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture and the entire carrying amount of the net investment in an associate or joint venture including the long-term interest be tested for impairment in accordance with IAS 36 as a single asset (paragraphs 14A and 42 of IAS 28).

24. We observe that diversity exists in the accounting for the amounts in the preceding paragraph[7]:

(a) When unrealised gains from downstream transactions exceed the carrying amount of the interest in the associate or joint venture:

(i) some entities reduce the carrying amount to zero and recognise a liability for the amount that could not be eliminated;

(ii) other entities reduce the carrying amount to zero but do not recognise a liability; if the investee earns a profit in subsequent periods, the carrying amount would be increased only after adjusting for the gain that had not been eliminated; and

(iii) yet other entities reduce the carrying amount to zero but do not recognise a liability; any profit the investee earns in subsequent periods is recognised without adjusting for the gain that had not been eliminated.

(b) When dividends from the investee exceed the carrying amount of the investment:

(i) some entities reduce the carrying amount to zero and recognise a liability for the amount that could not be eliminated;

(ii) other entities reduce the carrying amount to zero and do not recognise a liability but a gain for the amount that could not be eliminated; if the investee earns a profit in subsequent periods, the carrying amount would be increased only after adjusting for the gain that had not been eliminated; and

(iii) yet other entities reduce the carrying amount to zero and do not recognise a liability but a gain for the amount that could not be eliminated; any profit the investee earns in subsequent periods is recognised without adjusting for the gain that had not been eliminated.

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[7] In September 2014, the IASB amended IFRS 10 and IAS 28. That amendment would have required any gain or loss resulting from a downstream transaction involving assets that constitute a business between the investor and the associate or joint venture be recognised in full in the investor's financial statements (paragraph 31A of IAS 28). However, in December 2015, the IASB decided to defer the effective date of this amendment indefinitely.

25. We think a liability should be recognised for both cases for the following reasons:

(a) In the case of gains from downstream transactions, recognising a liability would enable the entity to fully eliminate the gains from downstream transactions. If a liability is not recognised, profit or loss will be reduced in the subsequent period(s). From the perspective of faithfully representing the income from the equity method investment, a liability should be recognised.

(b) In the case of dividends, recognising a gain is inconsistent with the notion that dividends from equity method investments are returns ***of*** investments rather than returns ***on*** investments. From the perspective of faithfully representing the income from the equity method investment, a liability should be recognised.

26. We note that in July 2013, the IASB agreed with the IFRS Interpretation Committee's recommendation that the entity should eliminate the gain from a downstream transaction to the extent of related investors' interest in the associate or joint venture, even if the gain to be eliminated exceeds the carrying amount of the entity's investment in the associate or joint venture, and that the remaining gain in excess of the carrying amount of the entity's investment in the associate or joint venture should be presented as a deferred gain[8]. However, in June 2015, the IASB decided to defer further work on this topic to the Equity Method research project.

27. We also note that those who are against recognising a liability argue that the gains from downstream transactions would not meet the definition of a liability as defined in the IASB's Conceptual Framework.

*Implications of this Principle*

28. The implications of Principle 2 can be summarised as follows:

(a) Impairment would be tested against the interest in the associate or joint venture in its entirety (that is, the single asset).

(b) A liability should be recognised when, and only when:

(i) the investor has legal or constructive obligations to absorb the losses; or

[8] IASB Update July 2013

(ii) the amounts that would otherwise be eliminated exceed the carrying amount of the investment.

*Potential Changes to IFRS Standards*

29. IAS 28 does not provide guidance on the accounting for cases where the amounts that would otherwise be eliminated exceed the carrying amount of the investment. Principle 2 would clarify the guidance in IAS 28 for such cases.

***Principle 3***

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| **Principle 3**: | Neither significant influence nor joint control constitutes control of an investee. Accordingly, the accounting requirements related to consolidations for the investor's ownership interests based on the concept of a group (a parent and its subsidiaries) shall not be carried over to the accounting requirements related to the equity method. |

*Rationale for this Principle*

30. The accounting requirements in IFRS 10 and IFRS 3 *Business Combinations* are based on the notion that obtaining control of another entity (that is, the investee becoming a subsidiary and thus part of the group) is a significant economic event. In the case of step acquisitions, this significant economic event warrants a change in accounting such that all of the investments previously made (regardless of whether IFRS 9 or IAS 28 had been applied) would be remeasured at fair value at the date control is obtained, with any difference in the carrying amount being recognised in profit or loss.

31. Neither significant influence nor joint control constitutes control of an investee. In our view, obtaining significant influence or joint control should not be viewed to be the same as obtaining control of an investee. Hence, the accounting requirements related to consolidations for the investor's ownership interests based on the concept of a group should not be carried over to the accounting requirements related to the equity method.

*Implications of this Principle*

32. The implications of Principle 3 can be summarised as follows:

(a) When control of an investee is obtained in steps, the investments previously made (regardless of whether IFRS 9 or IAS 28 had been applied) would be remeasured at fair value at the date control is obtained, with any difference recognised in profit or loss[9]. However, when significant influence or joint control is obtained in steps, the investments previously made may not be measured at fair value at the date significant influence or joint control is obtained[10].

(b) When the parent increases its interest in the subsidiary and that parent continues to control the subsidiary, the transaction would be viewed as a transaction with owners, and any difference between the consideration paid and the non-controlling interests reduced would be recognised in equity. However, when the investor increases its interest in the associate or joint venture and that investor continues to have significant influence or joint control over the associate or joint venture, the transaction would not be viewed as a transaction with owners.

(c) When the parent reduces its interest in the subsidiary and yet that parent continues to control the subsidiary, the transaction would be viewed as a transaction with owners, and any difference between the consideration received and the increase in non-controlling interests would be recognised in equity. However, when the investor reduces its interest in the associate or joint venture and yet that investor continues to have significant influence or joint control

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[9] For our view regarding the accounting for consolidations, refer to Part C of this paper.

[10] When significant influence or joint control is obtained in steps, our understanding is that more than one approach, including (1) the accumulated cost approach and (2) the fair value as deemed cost approach, is currently acceptable. Under (1) the accumulated cost approach, the investments previously made would have been measured at fair value in accordance with IFRS 9, and the changes from the initial cost would be reversed to measure the investments previously made at their initial costs. Under (2) the fair value as deemed cost approach, the investments previously made also would have been measured at fair value in accordance with IFRS 9, but the fair value when significant influence or joint control is obtained is deemed to be the cost of the investment previously made for the initial application of the equity method of accounting. Our understanding is that (1) and (2) represent different views on how to carry over the costs of the investments previously made when significant influence or joint control is obtained, and do not represent a remeasurement of the previously held investments at the acquisition date fair value as required by paragraph 42 of IFRS 3.

over the associate or joint venture, the transaction would not be viewed as a transaction with owners.

(d) When the parent's interest changes without any acquisitions or sales of interests by the parent (for example, when the subsidiary issues new shares to third parties) and the parent continues to control the subsidiary, any change in the parent's interest would be recognised in equity. However, when the investor's interest changes without any acquisitions or sales of interests by the investor (for example, when the associate or joint venture issues new shares to third parties) and the investor continues to have significant influence or joint control over the associate or joint venture, any increase in the interest would be accounted for in a manner consistent with acquisitions ((b) above) and any decrease in the interest would be accounted for in a manner consistent with sales ((c) above).

(e) A group's share in an investment is the aggregate of the holdings in that investment by the parent and its subsidiaries (that is, the group). The holdings in that investment by associates and joint ventures would be ignored. The same thinking applies to investments in the entity's own shares. When a parent has a subsidiary and that subsidiary holds an interest in the parent, such interest would be accounted for as treasury shares when the parent prepares consolidated financial statements. However, when the investor has an associate or joint venture and that associate or joint venture holds an interest in the investor, such interest would not be accounted for as treasury shares when the investor prepares consolidated financial statements.

*Potential Changes to IFRS Standards*

33. 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. However, it is unclear which procedures should follow the procedures in IFRS 10. Principle 3 would clarify the guidance in IAS 28 by focusing on the accounting requirements for the investor's ownership interests that refer to the concept of a group.

***Principle 4***

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| **Principle 4**: For issues that are not covered by Principles 1 to 3, the accounting requirements related to the equity method shall follow the accounting requirements related to consolidations. |

*Rationale for this Principle*

34. The equity method of accounting is applied to associates and joint ventures when the investor has significant influence or joint control. Because significant influence or joint control is not obtained by accident but only as a result of deliberate decisions by management, the existence of such significant influence or joint control warrants accounting that is closer to consolidation. The existence of significant influence or joint control indicates the investor's involvement in the management of the associate or joint venture, and that the performance of the investment should not merely be determined by the change in the fair value of the investment.

35. As discussed earlier in this paper, the current accounting requirements in IAS 28 are inconsistent with one-line consolidation in its purest form. Yet we are of the view that, subject to a few exceptions that are proposed in this paper, the accounting requirements related to the equity method generally should be consistent with the accounting requirements related to consolidations. Principle 4 is designed to cover residual items that are not covered by other principles. Because items covered by Principles 1 to 3 will be relatively limited, we believe that there will be many issues that would be covered by this principle.

36. The equity method of accounting is a technique to recognise the investor's share of the increase in the net assets of the associate or joint venture as the investor's income, which usually comes before the investor receives dividends from the associate or joint venture. Prior to IFRS 9, the equity method of accounting was a technique to recognise income or expense from equity investments earlier than when such investments were measured at historical cost. On the other hand, IFRS 9 requires equity investments to be measured at fair value (with changes in fair value being recognised in either profit or loss or other comprehensive income

(OCI)) and thus the equity method of accounting may not necessarily result in recognising income or expense from equity investments earlier. However, because of the investor's involvement in the management of the associate or joint venture, we are of the view that the equity method of accounting continues to be relevant even after the adoption of IFRS 9.

*Implications of this Principle*

37. The implications of Principle 4 can be summarised as follows[11]:

(a) The investor's share of profit or loss and OCI of the associate or joint venture would be recognised in the investor's profit or loss and OCI, respectively.

(b) The measurement of identifiable net assets of the associate or joint venture would follow the requirements in IFRS 3. Accordingly, the general principle on initial recognition would be to use fair value for measurement and the exceptions to recognition and measurement will be those prescribed in IFRS 3. This would include the requirement to measure contingent consideration at fair value.

(c) The concept of "measurement period" in IFRS 3 would also apply to associates and joint ventures.

(d) Unrealised gains and losses from upstream and downstream transactions would be eliminated.

(e) Receivables and payables (including loans and borrowings) between the investor and the associate or joint venture would be eliminated.

(f) Income and expenses that do not involve the transfer of assets between the investor and the associate or joint venture would be eliminated.

(g) When eliminating the unrealised gains from upstream transactions, the carrying amount of the asset (and not the carrying amount of the equity method investment) that is held by the investor would be adjusted.

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[11] For simplicity, the following discussions ignore any tax effects that may arise from the transactions.

(h) When Entity A holds an interest in Entity B and Entity B concurrently holds an interest in Entity A, such reciprocal interests would be eliminated when the equity method of accounting is applied to either Entity A or Entity B.

38. Regarding paragraph 37(d) of this paper, in the case of upstream transactions, the effects on profit or loss attributable to the parent would be the same for consolidations and the equity method of accounting. However, in the case of downstream transactions, the effects on profit or loss attributable to the parent would be different.

39. Regarding paragraph 37(e) of this paper, we observe that the guidance provided by large accounting firms suggest that receivables and payables (including loans and borrowings) between the investor and the associate or joint venture should not be eliminated. Some note that associates and joint ventures do not form part of the group and thus balances against entities outside of the group should not be eliminated.

40. However, we are of the view that the investor's share of the loans or borrowings should be eliminated against the carrying amount of the investment in the associate or joint venture. If we follow the argument in the previous paragraph, transactions with associates and joint ventures that give rise income and expenses also should not be eliminated, which would be inconsistent with the view that many hold, including the large accounting firms.

41. Consider the following example. The net assets of the associate are valued at CU1,000. The investor holds a 30% interest in the associate, valued at CU300. The investor also has a loan to the associate, valued at CU100.

42. For those entities that eliminate the receivables and payables between the investor and the associate or joint venture, the loan balance would be reduced by CU30 (CU100x30%). Because this would increase the net assets of the associate, the carrying amount of the associate would increase by CU30.

43. When an entity eliminates the receivables and payables between the investor and the associate or joint venture, the investor's receivables (payables) will decrease

and the carrying amount of the investment in the associate or joint venture will increase (decrease) by the same amount.

44. Regarding paragraph 37(f) of this paper, we observe that diversity exists in practice regarding the elimination of income and expenses that do not involve the transfer of assets between the investor and the associate or joint venture. Typical examples include interest and services. Some entities eliminate the investor's share of the income (expense) against the investor's share of the profit or loss of the associate or joint venture. Other entities do not make this adjustment.

45. Consider the following example. The net assets of the associate are valued at CU1,000. The investor holds a 30% interest in the associate, valued at CU300. The investor receives services from the associate and incurs expenses valued at CU100.

46. For those entities that eliminate the income and expenses between the investor and the associate or joint venture, the investor's expenses would be reduced by CU30 (CU100x30%). Because this would decrease the service revenue and thus the profit or loss of the associate, the investor's share in the profit or loss of the associate would decrease by CU30.

47. Applying the principles we propose in this paper, the adjustment will be made.

48. Regarding paragraph 37(g) of this paper, we observe that diversity exists in practice regarding how the unrealised gains from upstream transactions are eliminated. In an upstream transaction, the unrealised gain is included in the carrying amount of the asset held by the investor. Some entities eliminate the investor's share of the unrealised gains against the asset (such as inventory or property, plant and equipment) it purchased from the associate or joint venture. Other entities eliminate the investor's share of the unrealised gains against the carrying amount of the investment in the associate or joint venture.

49. Consider the following example. The investor holds a 30% interest in the associate, valued at CU300. The investor purchases property from the associate, which includes unrealised gains valued at CU100.

50. For those entities that adjust the carrying amount of the asset that the investor purchased from the associate or joint venture , the carrying amount of the property is reduced by CU30 (CU100x30%). For those entities that adjust the carrying amount of the investment in the associate or joint venture, the carrying amount is reduced by CU30.

51. Applying the principles we propose in this paper, the carrying amount of the asset purchased from the associate or joint venture will be adjusted.

*Potential Changes to IFRS Standards*

52. Principle 4 would clarify the guidance in IAS 28 by stating that, unless Principles 1 to 3 apply, the equity method of accounting should follow the accounting requirements related to consolidations. While many entities currently may not eliminate the investor's share of the loans or borrowings against the carrying amount of the investment in the associate or joint venture, elimination would be consistent with our view.

## Part C: Accounting for Consolidations

53. In Parts A and B of this paper, we have taken the requirements related to the accounting for consolidations as granted. However, in Part C, we present our views on the current requirements related to the accounting for consolidations.

54. As noted in paragraph 30 of this paper, the requirements in IFRS 10 and IFRS 3 are based on the notion that obtaining control of another entity (that is, the investee becoming a subsidiary) is a significant economic event that warrants a change in accounting such that all of the investments previously made would be remeasured at fair value at the acquisition date, with any difference recognised in profit or loss.

55. We do not believe this accounting treatment represents the event faithfully, because the required accounting would have the same effect as if the entity sells the investments previously made at fair value at the acquisition date. The fact is that the investments previously made have not been sold. It would be difficult to say

that the faithful representation of an additional purchase of shares would involve the accounting for the sales of the previously held shares.

56. Accordingly, in the case of step acquisitions, we are of the view that investments previously made should not be remeasured when the investor obtains control. Instead, we think that the carrying amounts of the investments should be carried over.

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