IFRS Accounting

Staff paper

GPF Agenda Reference: 5

Global Preparers Forum meeting

Date	**11 November 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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Purpose of this session*

- To provide GPF members with an update on the equity method project.
- To ask GPF members for views on *four* possible alternatives 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.*

* Questions for GPF members are set out in slide 13 of this deck.

Agenda

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

Introducing the application question

Introducing 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?

The IASB is exploring *four* alternatives, discussed at its September 2022 meeting, to answer the application question*.

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.

* Agenda Paper 5A of this meeting is a copy of an agenda paper presented to the IASB at its September 2022 meeting. It further explains the history of this inconsistency, the amendment issued in 2014 and the *four* alternatives, including the staff analysis, their advantages and disadvantages and which IFRS Accounting Standards would need to be amended.

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Summary of *four* alternatives to answer the application question

Summary of the *four* alternatives discussed by the IASB*

<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 5A to this meeting. For further details of the IASB's discussion at its September 2022 meeting, refer to [IFRS - IFRS webcast](#).

Summary of the *four* alternatives discussed by the IASB

Alternative 1

Full gain would be recognised on all contributions/sales of assets or businesses, regardless of whether they are housed or not in a subsidiary.

No elimination entries' requirements apply.

Rationale

Alternative 1 is consistent with an alternative the IASB discussed, within the 2014 Amendment, but did not proceed with. In 2014 the IASB's thinking was to follow IFRS 3 *Business Combinations* and IFRS 10 for all contributions/sales.

The role of the elimination entries in IAS 28 is questionable because this elimination is a consolidation procedure.

Alternative 2

Partial gain would be recognised on all contributions/sales of assets or businesses, regardless of whether they are housed or not in a subsidiary.

Retains on the elimination entries' requirements.

Rationale

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

Consistent with paragraph 30 of IAS 28; for the derecognition of an asset the overlay approach *is* used but it *is not* used for the derecognition of a business.

* An overlay approach is about the general mechanics of how the Standards interact with each other. For further explanation of those two steps, refer to paragraphs B17–B24 of Appendix B of Agenda Paper 5A to this meeting.

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Summary of the *four* alternatives discussed by the IASB

Alternative 3

Is a mixture of Alternative 1 and Alternative 2. *Full* gain would be recognised on transactions *out* of the scope of IFRS 15 *Revenue from Contracts with Customers*. *Partial* gain would be recognised on transactions *in* the scope of IFRS 15.

No elimination entries' requirements apply for transactions *out* of the scope of IFRS 15.

Rationale

Assumes users *disregard* gains or losses *(or value them differently)* on transactions that are *not* in the scope of IFRS 15 (ie *not* an output of an entity's ordinary activities) because those transactions are often non-recurring. Therefore, the gain or loss recognised would *not* be restricted in this case.

Alternative 4

Revives the 2014 Amendment.
Full gain would be recognised when a transaction involves a business. *Partial* gain would be recognised when a transaction involves an asset.

No elimination entries' requirements apply when a transaction involves a business.

Rationale

IFRS 10's requirements arose from the Business Combinations project, ie apply to businesses.

Group of assets that do not constitute a business were not part of that project, ie no reason to change the accounting for these contributions.

Questions for GPF members

Questions for GPF members

Q1. Which of the alternatives, those set out on slides 9–11 (paragraph 33 of Agenda Paper 5A of this meeting), do you think, provides a faithful representation of the transaction set out in the application question? Please explain why.

Q2. How frequently do you encounter the transaction set out in the application question? If you have encountered it, did you apply one of the *four* alternatives?

Q3. How much change to current practice do you think applying each alternative would involve?

Q4. Can you obtain the information required for the equity method of accounting? For example, when gains and losses are restricted on downstream transactions, can you monitor whether an asset remains in an associate’s books in subsequent periods?

Appendix—Illustrative example of a downstream transaction between an investor and its associate

Illustrative example of a downstream transaction*

A downstream transaction where:

- an investor owns 40% of an associate;
- the investor sells inventory to the associate at a transaction price that is arm’s length;
- the investor applies IFRS 15 and sells the inventory to the associate for CU850, recognising a CU250 gain; and
- as of the reporting date, all the inventory remains in the associate stocks (ie not sold yet to third-party).

Alternative 1	*Full* gain of CU250 would be recognised.
Alternative 2	*Partial* gain of CU150 (CU250 x 60%) would be recognised. The investor recognises only the gain to the extent of the unrelated investors’ interests in the associate by eliminating its portion of the gain by CU100 (CU250 x 40%).
Alternative 3	It depends. Because selling inventory is, usually, on the scope of IFRS 15, the outcome will be similar to Alternative 2—ie *partial* gain of CU150 would be recognised.
Alternative 4	Similar to Alternative 2—ie *partial* gain of CU150 would be recognised.

* For simplicity, the illustrative example describes *only* the basic idea of how the elimination entries’ requirements work; it does not illustrate a transaction that results in the loss of control of a subsidiary or a subsidiary/an asset that may constitute a business. For further details of the history of this inconsistency, including the amendment issued in 2014, whose effective date was deferred indefinitely, refer to paragraphs A1–A14 of Appendix A of Agenda Paper 5A to this meeting.

Thank you

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

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