EFRAG
European Financial Reporting Advisory Group

11 February 2014

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Equity Method in Separate Financial Statements (Proposed amendments to IAS 27), exposure draft

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2013/10 *Equity Method in Separate Financial Statements* (proposed amendments to IAS 27), issued by the IASB on 2 December 2013 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG is generally not in favour of introducing accounting policy options in IFRS, as it reduces the comparability of financial information. Nevertheless, we acknowledge that the equity method may provide informative reporting of the investor's net assets and profit or loss in its separate financial statements. Therefore, EFRAG is not against the IASB's proposal to allow entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements. Still, we believe that the IASB should better articulate the reasons for re-introducing the equity method in the separate financial statements.

In addition, EFRAG thinks that:

(a) the IASB should explain better in the Basis for Conclusions why it believes the consequential amendment to IAS 28 *Investments in Associates and Joint Ventures* is necessary and how it improves the quality of financial reporting in the separate financial statements;

(b) relief should be provided from full retrospective application to entities that opt to use the equity method to account for subsidiaries in their separate financial statements;

(c) the IASB should introduce a transitional relief for first-time adopters. Such relief should be based on the exemptions provided in paragraphs C1 and C5 of IFRS 1; and

(d) the IASB should take this opportunity to clarify the objective of separate financial statements even though this should be considered more comprehensively in the future as part of IASB's research activities.

Finally, we note that the amendments proposed to paragraph 25 of IAS 28 do not seem to reflect the intention of the Board as stated in paragraph BC11 of the ED.

Our detailed comments and responses to the questions in the ED are set out in Appendix A. Furthermore, we include for your information an EFRAG consultation paper on the nature of the equity method, which we believe is also relevant in the context of this ED (see Appendix B).

If you would like to discuss our comments further, please do not hesitate to contact Filipe Camilo Alves, Hocine Kebli or me.

Yours faithfully,

Françoise Flores
EFRAG Chairman

APPENDIX A

Question 1 – Use of the equity method

The IASB proposes to permit the equity method as one of the options to account for an entity's investments in subsidiaries, joint ventures and associates in the entity's separate financial statements.

Do you agree with the inclusion of the equity method as one of the options? If not, why?

EFRAG's response

EFRAG agrees that the equity method may provide informative reporting of the investor's net assets and profit or loss. However, the IASB should better articulate the reasons for re-introducing the equity method in the separate financial statements.

Use of the equity method in separate financial statements

1 EFRAG is generally not in favour of introducing accounting policy options in IFRS, as it reduces the comparability of financial information. Nevertheless, we acknowledge that (as noted in paragraph BC8 of the ED) the equity method may provide informative reporting of the investor's net assets and profit or loss in its separate financial statements. Therefore, EFRAG is not against the IASB's proposal to allow entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements.

2 However, EFRAG thinks that the IASB has not sufficiently clearly articulated the reasons for re-introducing the equity method in the separate financial statements. In particular, we believe that:

(a) if the main objective of the proposals is to improve relevance of information provided to users then the IASB should first clarify what the equity method aims to achieve. EFRAG has published a consultation paper on the nature of the equity method, which we attach for your information (see Appendix B).

(b) under the approach proposed in the ED, the resulting cost-savings arising are small and seem limited to accounting for associates and joint ventures. If the main purpose of the ED is to provide effective relief to preparers then we suggest that the IASB also investigate the current practice and recommendations of countries such as the Netherlands and Denmark, which have a long experience in applying the equity method in separate financial statements.

(c) if the objective of the proposals is to encourage the broader adoption of IFRS by entities that prepare separate financial statements then IASB should clearly state this.

Application of the equity method to investments in subsidiaries

3 EFRAG welcomes the clarifications provided in paragraphs BC9 and BC10 of the ED about the application of the equity method in separate financial statements. More specifically, the clarification that there could be situations in which applying the equity method to investments in subsidiaries in separate financial statements would give a different result compared to the consolidated financial statements.

4 Paragraph BC10 of the ED only refers to the impairment of goodwill as an example where differences can occur. However, we note that further differences may, for example, arise in accounting for the costs of acquisition, step acquisitions, application of consolidation elimination procedures, accounting for loss-making subsidiaries and capitalisation of borrowing costs on assets of a subsidiary. Therefore, we believe that the Basis for Conclusions should explain how the Board concluded that creating any additional guidance within IAS 28 would not be appropriate and why these differences would not pose a problem in the view of the Board.

Definition of separate financial statements

5 We acknowledge that reinstating the option to use the equity method in separate financial statements will require changes to the definition of separate financial statements.

6 We believe that the new definition should emphasise the main feature that distinguishes separate financial statements, namely: separate financial statements focus on the parent or investor (in associates and joint ventures) and on the performance of the assets as investments. Similarly, we also believe that the IASB should take this opportunity to clarify the objective of separate financial statements so as to provide a more robust basis when difficulties of application of IFRS to separate financial statements arise in practice. This would be a helpful improvement at this stage, even though the objective of separate financial statements should be considered more comprehensively in the future as part of IASB's research activities.

Question 2 – Transition provisions

The IASB proposes that an entity electing to change to the equity method would be required to apply that change retrospectively, and therefore would be required to apply IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Do you agree with the proposed transition provisions? If not, why and what alternative do you propose?

EFRAG's response

EFRAG thinks that the IASB should provide relief from full retrospective application to entities that opt to use the equity method to account for subsidiaries in their separate financial statements.

7 EFRAG is usually in favour of full retrospective application because this provides more useful information to users as it facilitates a year-to-year comparison. However, EFRAG is aware that such application may be costly and in some cases impracticable.

8 Paragraph BC12 of the ED notes that an entity does not need to perform any additional procedures when accounting for investments in associates and joint ventures as such investments are accounted for using the equity method in the consolidated financial statements. However, as noted in paragraph 12 above, there are many instances in which differences can arise between the separate and consolidated financial statements in the application of the equity method to subsidiaries. Therefore, EFRAG does not believe that it is always possible to derive the carrying amount under the equity method directly from the consolidated

financial statements; rather, determining the proper carrying amount may require considerable additional effort.

9 EFRAG thinks that the IASB should provide a relief on a similar basis to the one in IFRS 11 *Joint Arrangements.* That is, the IASB should allow entities that opt to use the equity method to account for their investments in subsidiaries at the beginning of the immediately preceding period at an amount which corresponds to the net asset amount in the consolidated financial statements.

Question 3 – First-time adopters

The IASB does not propose to provide any special relief for first-time adopters. A first-time adopter electing to use the equity method would be required to apply the method from the date of transition to IFRSs in accordance with the general requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Do you agree that a special relief is not required for a first-time adopter? If not, why and what alternative do you propose?

EFRAG's response

EFRAG believes that the IASB should introduce a transitional relief for first-time adopters. Such relief should be based on the exemptions provided in paragraphs C1 and C5 of IFRS 1.

10 EFRAG considers that the IASB's proposal to apply the equity method retrospectively can be costly and difficult, or even impossible, for first-time adopters that elect to use the equity method to account for investment in subsidiaries, joint ventures and associates.

11 We disagree with paragraph BC14 of the ED, which states that the same considerations for entities already applying IFRSs can also be applied to first-time adopters. Even when local regulations allow the equity method, the differences between IFRS and local accounting requirements can be significant. For example, in accordance with its previous GAAP, a first-time adopter may not have consolidated a subsidiary acquired in a past business combination because the parent did not regard it as a subsidiary in accordance with previous GAAP or did not prepare consolidated financial statements.

12 EFRAG notes that paragraphs C1 of IFRS 1 provides an exemption for past business combinations and paragraph C5 of IFRS 1 extends that exemption to past acquisitions of investments in associates and of interest in joint ventures. EFRAG believes that the IASB should introduce a transitional relief for first-time. Such relief should be based on the exemptions provided in paragraphs C1 and C5 of IFRS 1.

13 Finally, we believe that the IASB should clarify whether the 'deemed cost' relief in paragraph D15 of IFRS 1 would also be applicable to subsidiaries accounted for under the equity method. We believe that this might be appropriate given that under the equity method an investment is initially measured at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee (paragraph 2 of IAS 28). Alternatively, the IASB should consider a 'deemed cost' approach that takes the net asset value of the subsidiary in its consolidated financial statements as a starting point.

Question 4 – Consequential amendment to IAS 28 *Investments in Associates and Joint Ventures*

The IASB proposes to amend paragraph 25 of IAS 28 in order to avoid a conflict with the principles of IFRS 10 *Consolidated Financial Statements* in situations in which an entity loses control of a subsidiary but retains an ownership interest in the former subsidiary that gives the entity significant influence or joint control, and the entity elects to use the equity method to account for the investments in its separate financial statements.

Do you agree with the proposed consequential amendment? If not, why?

EFRAG's response

EFRAG believes that the IASB should explain better in the Basis for Conclusions why it believes the amendment to IAS 28 is necessary and how it improves the quality of financial reporting in the separate financial statements.

14 Paragraph BC11 of the ED states that the IASB proposed the amendment to paragraph 25 of IAS 28 to avoid any conflict with the principles of IFRS 10, which requires an entity to recognise any investment retained in a former subsidiary at its fair value when control is lost.

15 EFRAG believes that the amendment proposed to paragraph 25 of IAS 28 does not seem to reflect the intention of the Board as expressed in paragraph BC11 of the ED and would need to be redrafted. EFRAG considers that the revised wording of IAS 28 does not require an entity to remeasure any retained investment to fair value if an investor loses control over a subsidiary and retains an interest in the former subsidiary. In fact, we consider that it only addresses situations in which a parent sells a partial interest in a subsidiary, but retains control (e.g. sells 20% out of 100%).

16 However, more importantly, we believe that while the change proposed in paragraph BC11 of the ED might solve one potential inconsistency, it creates several other inconsistencies:

(a) The proposed treatment would only apply when a subsidiary is accounted for under the equity method, but it remains unclear whether the treatment would apply when there is loss of control of a subsidiary that is accounted for at cost or fair value;

(b) Paragraph 24 of IAS 28 requires continued application of the equity method when an investment in a joint venture becomes an investment in an associate, or vice versa. Paragraph BC30 of IAS 28 explains that the IASB changed the previous requirements in IAS 28, which had required revaluation, on the grounds that 'Considering that there is neither a change in the group boundaries nor a change in the measurement requirements, the Board concluded that losing joint control and retaining significant influence is not an event that warrants remeasurement of the retained interest at fair value'. It is not clear why the same logic should not apply to accounting for investments in subsidiaries in separate financial statements; and

(c) Paragraph BC11 of the ED should be redrafted to consider specifically the fact that an entity may apply different measurement bases (i.e. fair value, cost or equity method) for its investments in subsidiaries, associates and joint ventures. For example, the loss of control over an equity-accounted subsidiary could trigger the recognition of a counterintuitive revaluation gain, even if the investor measured its associates at cost.

17 Therefore, EFRAG does not agree with the IASB's conclusion in paragraph BC11 of the ED and believes that the IASB should explain better in the Basis for Conclusions why it believes the amendment to IAS 28 is necessary and how it improves the quality of financial reporting in the separate financial statements. Furthermore, the IASB should clarify to what extent this treatment would also be applicable to subsidiaries accounted for under the cost method.

Question 5 – Other comments

Do you have any other comments on the proposals?

18 EFRAG considers that there is uncertainty on how to account for an investment when it changes status from being, for example, a subsidiary to an associate (or vice-versa), and the entity has elected a different measurement option for each category of investments. To ensure consistent application in practice, EFRAG recommends the IASB to clarify the accounting for of such changes.

APPENDIX B: EFRAG consultation paper on the nature of the equity method

European Financial Reporting Advisory Group

EFRAG Short Discussion Series

THE EQUITY METHOD: A MEASUREMENT BASIS OR ONE-LINE CONSOLIDATION?

JAN 2014

The EFRAG Short Discussion Series addresses topical and problematic issues with the aim of helping the IASB to address cross-cutting dilemmas in financial reporting and stimulating debate among European constituents and beyond.

Further information about the work of EFRAG is available on www.efrag.org

We welcome views on any of the points addressed in this paper. Specific questions are given at the end of the document. These comments should be sent by email to commentletters@efrag.org or by post to

EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

So as to arrive no later than 15 May 2014.

All comments will be placed on the public record unless confidentiality is requested.

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INTRODUCTION

1 Over the years, the IFRS Interpretations Committee has received numerous requests to clarify various aspects of accounting under the equity method in IAS 28 *Investments in Associates and Joint Ventures* (2011).

2 IAS 28 applies to all entities that are investors with joint control of, or significant influence over, an investee, with some exceptions permitted. When developing IFRS 11 *Joint Arrangements*, the IASB decided to remove the option to apply proportionate consolidation to jointly controlled entities that existed under IAS 31 *Interests in Joint Ventures*. The scope of the equity method under IFRS has therefore been widened.

3 In May 2012, the IASB added a research project on the equity method of accounting to its agenda. However, this project remains at an early phase of development. As an interim solution, the IASB has been considering the various requests for guidance through narrow-scope amendments to IAS 28. In December 2012, the IASB published two Exposure Drafts addressing various inconsistencies within the Standard.

4 When responding to the two proposed amendments to IAS 28, EFRAG and other respondents expressed their support for the efforts of the IASB to address the diversity in practice but also commented that the proposed amendments lacked a clear conceptual basis and were potentially inconsistent with each other. It was noted that IAS 28 contains elements of both consolidation techniques and a measurement basis; however it was not always clear which of the two concepts should be applied to those situations that were not specifically addressed in IAS 28.

5 In December 2013, the IASB issued a proposal to allow entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate (parent only) financial statements. The basis for conclusions for that proposal does not explain why the equity method is an appropriate basis for accounting for investments in the separate financial statements. The proposals are intended to serve as a practical expedient to address a specific narrow-scope issue. A further exposure draft on the elimination of gains on downstream transactions between an investor and its equity-accounted investee is expected in early 2014.

6 EFRAG is also aware that accounting firms have developed extensive application guidance on the application of the equity method for areas not addressed in IAS 28. The IFRS guidance published by accounting firms often reflects a range of views on accounting for specific transactions under the equity method and it is not always clear which of the two underlying concepts should be applied to those transactions and why.

7 Given the concerns and lack of clarity on the application of the equity method, it is increasingly important for those applying IFRS to have a better understanding of what the equity method aims to achieve in reporting for an investment in an associate or a joint venture ('the investment' or 'investee') in the statement of financial position and statement(s) of profit or loss and other comprehensive income.

OBJECTIVE OF THIS PAPER

8 The objective of this paper is to highlight some considerations that are relevant in the discussion about the equity method and to ask for the views of constituents. This paper analyses the equity method from the perspective of the consolidated financial statements only. The impacts on the separate financial statements are not discussed.

9 This paper considers to what extent the equity method is a measurement basis, a one-line consolidation or whether it is a hybrid that has characteristics of both. The answers to these questions could affect the way standard setters further develop the equity method in the future.

10 This paper also considers whether recent developments in IFRS could assist in formulating a view on the equity method. However, the objective of the paper is not to reach a conclusion on this.

11 This paper intends to:

(a) assist the IASB to develop a clear set of principles for the basis of the equity method, before they address inconsistencies through additional narrow-scope amendments to IAS 28;

(b) contribute to the IASB's research project on the equity method; and

(c) stimulate debate within Europe on the equity method of accounting.

12 The paper is also relevant to work the IASB is conducting on the revision to the *Conceptual Framework for Financial Reporting* and particularly the chapter on the Reporting Entity.

BRIEF HISTORY OF THE EQUITY METHOD

13 The equity method arose as a form of consolidation for subsidiaries in the UK and for certain subsidiaries in the US before the principles of full consolidation had been accepted.[1] In particular, consolidated financial statements were seen as inappropriate because they showed assets and liabilities not owned by the reporting entity.

14 However, a cost basis for recognising investments in subsidiaries in the statement of financial position together with revenue based on the recognition of dividends was criticised for not recognising losses in subsidiaries on a timely manner and not adequately reflecting the performance of subsidiaries given retention of earnings. The equity method had the benefit of allowing the incorporation of actual results of subsidiaries into an entity's financial statements.

[1] An Analysis of the International Development of the Equity Method, Christopher Nobes, ABACUS, Vol. 38, No 1, 2002.

15 The equity method therefore evolved, before the widespread use of consolidation, as a way of depicting the performance of subsidiary entities. It was seen as more appropriate than cost because:[2]

(a) 'The cost method makes sense when there is uncertainty but that does not apply to subsidiaries over which there is full control of dividend policy.

(b) The status of the investments varies with the fortunes of the investees not with the movements of cash. Income accrues as the investments increase in value. Income accrues to the parent when it accrues to the subsidiary.

(c) The validity of the subsidiary's profit calculation is as well established as the parent's.

(d) Because companies plough back part of their profits, the cost rule will probably understate parent income in prosperous periods.'

16 The equity method was later used to account for non-consolidated subsidiaries in the consolidated financial statements and for subsidiaries in the parent entity's separate financial statements. In later years (1960s), it began to be recommended also for investments in certain non-subsidiary investees. It should be noted that the use of the equity method to account for subsidiaries in the parent entity's separate financial statements has remained a long-standing practice that is still used in various jurisdictions across the world.

17 During the 1960s it was recognised that there was a case for an intermediate form of accounting, given the tendency for parent entities to conduct a significant part of their businesses by acquiring substantial (but not controlling) stakes in other entities and exercising a significant degree of influence over those acquired investments. Mere recognition of dividends was seen to be an inadequate measure of the results of the investments held by a parent entity. The equity method of accounting seemed to serve the need for such an intermediate form of accounting – which was based on the cost of an investment, recognition of dividends and 'something else' – in order to appropriately reflect the results of the underlying investment in the financial statements of an investor.

18 However, the equity method was not supported by everyone. In the UK, for example, some criticised the method on the basis that it lacked an element of 'conservatism', following a court decision which interpreted the equity method as allowing for the recognition of unrealised profit. Nonetheless, international consensus on the equity method led to an amendment of the EC Seventh Directive (final version of 1983) to require the use of the equity accounting for associates of an investor.

[2] Moonitz, 1944 in Nobes, 2002.

19 Some European countries questioned this amendment given that historically the equity method had been used as a substitute for consolidation and was mainly used to account for ‘controlled’ entities (subsidiaries). In Germany, for example, the concept of a ‘group’ meant that associates were not group companies – only the parent company and its subsidiaries were. In other countries, like Sweden, doubt was cast over whether the equity method was a legally acceptable measurement method. Nobes (2002) states that these legal doubts were partially resolved by considering the equity method as a form of consolidation rather than as a measurement basis (referred to as ‘valuation method’ in the article).

20 Other countries, like Australia, amended their local GAAP (AASB 1016 in 1998) to require the use of the equity method in the consolidated accounts but, similar to Germany, associates were considered to be outside the group reporting entity therefore they too considered the equity accounting to be a measurement basis rather than a consolidation approach.

21 Despite this long history of the development of the equity method, IAS 28 does not state what the equity method is trying to portray. This leads to questions when there is no specific requirement in the Standard dealing with a particular type of transaction.

22 The equity method of accounting has features of both a consolidation approach (e.g. the elimination of profits and losses from upstream and downstream transactions) and a measurement basis (e.g. the non-recognition of losses in excess of carrying value in most circumstances).

23 In summary, whether the equity method is considered to be a consolidation technique, a measurement basis or a hybrid with characteristics of both has been discussed for several decades and support for each of the approaches seems to have developed for different, often legal, reasons.

MECHANICS OF THE EQUITY METHOD UNDER CURRENT IAS 28

24 IAS 28 was originally issued in 1989 and has been subject to a number of amendments, most notably the amendments issued in December 2003 that resulted in a significantly revised version of IAS 28 which became effective on or after 1 January 2005. However the basic mechanics of the equity method remained unchanged.

25 IAS 28 requires an investment to be accounted for using the equity method from the date on which it becomes an associate or a joint venture. Investments held through venture capital or other similar holdings may be held at fair value and are not covered in this paper.

26 IAS 28 (paragraph 3) defines the equity method as:

'a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income'.

27 This results in an investor's pre-tax earnings including the investor's proportional share of the post-tax earnings of the investee.

28 The problem is that different views of the concepts of the equity method lead to diverse accounting treatments for the same transaction.

Equity method as a measurement basis

29 IAS 28 contains certain requirements that indicate that the equity method is about measurement of an asset rather than being a one-line consolidation. For example, an investor does not account for its share of losses in an equity-accounted investee if those losses exceed the carrying amount of the investor's interest unless the investor has an obligation to meet future losses. In that case it would be required to recognise that obligation as a liability.

30 Measuring investments at cost could be seen as inappropriate when the investor is able to control the payment of dividends from the investee. The earliest uses of the equity method, before the spread of consolidation, were to ensure the recognition of losses and restrict the potential for inappropriate recognition of gains.

31 Nobes (2002) describes this saying 'this use of the equity method in investor financial statements could be seen as an example of attempts by accountants to express commercial substance over legal form. Since an investor could usually obtain its share of profits in a subsidiary merely by requesting them, to recognise only dividends might seem like a legal nicety. A clue to another rationale for the use of equity accounting in investor financial statements can be found in the Dutch term for the method: *intrinsieke waarde* (intrinsic value)'.

32 The basis for conclusions in IAS 28 (paragraphs BC20, BC21 and BC30) refers to the equity method as a way to measure an investment in an associate and a joint venture (paragraph BC30). For example, paragraph BC20 refers to a situation where different measurement bases can be applied to portions of an investment in an associate in certain circumstances and refers to the equity method as being a way to measure an investment.

33 More recently an IASB Board Member, Mr Ochi, dissented to the publication of ED/2012/3 *IAS 28 Equity Method: Share of Other Net Asset Changes* on the basis that, under the equity method of accounting, the investment is only adjusted for the post-acquisition changes in the investor's share of the investee's net assets. He added that, in his view, the equity method does not represent a one-line consolidation at the time of acquisition or disposal of the investment.

34 More generally, an asset is defined in paragraph 4.4(a) of the *Conceptual Framework for Financial Reporting* as 'a *resource* controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.' As an investor does not control the underlying assets of an equity-accounted investee, they do not meet the definition of assets and should therefore not be recognised as if they were. The interest of an investor is therefore the investment in the investee, which meets the conceptual definition of an asset.

Equity method as a one-line consolidation

35 Paragraph 26 of IAS 28 notes that many procedures appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10 *Consolidated Financial Statements*. This same paragraph adds that the concepts used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an investee. IFRS 3 *Business Combinations* addresses the accounting for acquisition of subsidiaries.

36 IAS 28 generally requires unrealised profits on transactions with equity-accounted investees to be eliminated to the extent of the investor's interest in the investee. This is reflected, for example, in the accounting relating to 'upstream' and 'downstream' transactions between an investor (including its consolidated subsidiaries) and its investee, in which the investor's share of gains that arise from such transactions are eliminated. It is also reflected in the accounting for contributions or sales of assets to an investee by an investor, except in the circumstances set out in paragraph 31 of IAS 28 which addresses a specific situation in which the investor is required to recognise the full gain or loss in its profit or loss. The elimination of profits only to the extent of an investor's interest reflects a proprietary perspective to consolidation, as opposed to the entity perspective of IFRS 10.

37 IAS 28 also says that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an investee. Although the Standard does not specifically say that IFRS 3 should be applied to an acquisition of an investee, it does refer to the acquisition accounting principles in IFRS 3. Specifically, IAS 28 requires any difference between the cost of the investment and the investor's share of the net fair value of the investee's identifiable assets and liabilities to be accounted for as follows:

(a) goodwill relating to an investee is included in the carrying amount of the investment; or

(b) any excess of the investor's share of the net fair value of the investee's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the investor's share of the investee's profit or loss in the period in which the investment is acquired.

RECENT DEVELOPMENTS

38 Recent developments in IFRS could assist in formulating a view on the equity method and what it aims to portray.

Recently proposed narrow-scope amendments to IAS 28

39 In December 2012, the IASB published the following two Exposure Drafts proposing to amend IAS 28:

(a) ED/2012/3 *IAS 28 Equity Method: Share of Other Net Asset Changes* – Addressed how an investor should recognise its share of changes in net assets of an investee not recognised in comprehensive income ('other net asset changes'); and

(b) ED/2012/6 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* – Addressed the acknowledged inconsistency between IFRS 10 and IAS 28 dealing with sale or contribution of assets between an investor and its investee.

40 Respondents to the Exposure Drafts mentioned above raised a number of concerns. In particular, they noted that:

(a) The diversity in the way the equity method was applied in practice arose mainly because of two different views of the concepts underlying the equity method. The narrow-scope amendments did not address these two concepts and were seen as a 'patch' to deal with missing guidance or addressing inconsistencies in IAS 28. Although there was some acceptance of these short-term pragmatic solutions to address diversity in practice, they did not present a robust solution to the underlying issues.

(b) It was important for the IASB to establish a clear conceptual basis for the equity method (i.e. one-line consolidation or measurement basis) in order to address issues regarding its application.

41 In December 2013, the IASB issued a proposal to allow entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements.

42 A further exposure draft on how to account for the elimination of gains arising on downstream transactions when using the equity method is expected to be published soon. The IASB has tentatively decided that an investor should eliminate its share of gains and losses on transactions with an investee, even if the share of the gain it needs to eliminate exceeds the carrying amount of its interest in the investee. Any excess would be presented as a deferred gain.

Unit of account

43 Some of the IASB's recent decisions explain that an investment in an associate or joint venture is a single unit of account, rather than the individual assets and liabilities of the investee. An investor has significant influence over its investment in an associate or joint venture, not over the individual assets and liabilities of the investee. For example, the following amendments reflect this view:

(a) A 2008 amendment to IAS 28, which is explained in paragraph BCZ45 of IAS 28 as 'The Board decided that an entity should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associate or joint venture because the investment is the only asset that the entity controls and recognises'.

(b) A 2009 amendment to IAS 39 *Financial Instruments: Recognition and Measurement*, which is explained in paragraph BC24D as '...the acquisition of an interest in an associate represents the acquisition of a financial instrument. The acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent net assets. The Board noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates.[3] This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures.'

44 In February and March 2013, the IASB discussed the interaction between the unit of account of investments in subsidiaries, joint ventures and associates and their measurement at fair value. An Exposure Draft on this topic is expected to be published by the IASB soon. The IASB agenda papers noted that the question asked by constituents, related to whether the fair value of these investments should reflect the measurement of the investment as a whole or of the individual financial instruments included within that investment. The IASB tentatively decided that the unit of account for investments in subsidiaries, joint ventures and associates is the *investment as a whole*.

[3] Paragraph 26 in the current version of IAS 28.

45 The IASB's tentative decision that an investment in an associate is the investment as a whole could be further supported if the equity method was considered to be a measurement basis, rather than a one-line consolidation technique. It would also be consistent with other recent IASB decisions that the unit of account of an associate is the investment asset.

Shift to 'exclusive control' as the basis for consolidation

46 Another relevant consideration is the shift towards 'exclusive control' in the IASB's recent conceptual thinking and standard setting process as reflected in IFRS 3 and the new requirements of IFRS 10 and IFRS 11.

47 IFRS 10 focuses on a single basis of consolidation based on 'control'. The definition of control, in the context of consolidated financial statements, focuses on a parent entity (the investor) and its subsidiaries. This is because all other types of investees held by a parent entity are excluded from the definition of the group (as defined in IFRS) in the context of the parent entity's consolidated accounts.

48 The recognition principles in IFRS 3 also focus on the concept of 'control'. They apply when an entity acquires another entity that is considered a business and obtains control over that entity. IFRS 3 explains that when control is achieved through a step acquisition (an acquisition in stages) the boundaries of the group change: the reporting entity gains control over a subsidiary, and any previously held interest is derecognised and remeasured at fair value at the date control is obtained and used in the determination of goodwill. The related gain or loss is recognised in full in profit or loss.

49 Similarly, when control is lost, the boundaries of the group change. IFRS 10 requires the former subsidiary to be derecognised and any retained interest to be remeasured at fair value, with the resulting gain recognised in full in profit or loss. If an investor retains an interest in a pre-existing subsidiary, that is regarded as being a new investment of a different nature (as the parent-subsidiary relationship ceases to exist).

50 However, changes in ownership interest in a subsidiary while retaining control are accounted for as transactions with owners in the capacity as owners. Contrary to step-acquisitions and loss of control, no gain or loss on such changes is recognised in profit or loss; instead, it is recognised in equity.

51 One could argue that the principle of exclusive control is also reflected in the requirements of IFRS 11: proportionate consolidation is no longer permitted as a method for accounting for interests in joint arrangements (previously called joint ventures). Paragraph BC11 of IFRS 11 argues that the accounting for joint arrangements should reflect the rights to assets and obligations for liabilities that the parties have as a result of their interests in a joint arrangement. If a party has neither rights to assets nor obligations for liabilities in an arrangement, it recognises its share in the joint arrangement under the equity method as this reflects the fact that the party has only rights to the net assets of the joint arrangement.

POSSIBLE CONSIDERATIONS OF THE ACCOUNTING OUTCOMES

52 Whether the equity method is considered to be primarily a method of consolidation, a measurement basis or a hybrid that has characteristics of both, could affect the way standard setters further develop the equity method in the future. In particular, the accounting for the following transactions could be significantly different:

(a) acquisition of an interest in an investee, including additional interest with no change in investment status;

(b) transactions with equity-accounted investees; and

(c) accounting for share of other net asset changes.

53 A high-level analysis of the possible accounting outcomes of (a), (b) and (c), assuming that the equity method is either a measurement basis or a one-line consolidation, is set out in the paragraphs below.

Acquisition of an interest in an investee, including additional interests with no change in investment status

Measurement basis

54 Acquisition of an interest in an associate or joint venture would be accounted for at cost on the date of acquisition. Transaction costs incurred would be added to the cost of the underlying investment.

55 This principle would also apply when additional interests in the associate or joint venture are acquired, without a change in status in the investment (i.e. the investor continues to apply the equity method). Therefore, the consideration paid (including transaction costs) for the additional interest would be added to the investment measurement.

One-line consolidation

56 If the equity method were to be considered a pure consolidation approach, the principles in IFRS 3 would apply on the date of acquisition of an interest in an associate or joint venture. Transaction costs incurred would be expensed in profit or loss. Goodwill would be recognised (within the one line on the statement of financial position) to the extent of the excess of cost over the investor's share of the fair value of identifiable net assets. 'Negative goodwill' would be accounted for in profit or loss.

57 These principles would also apply when additional interests are acquired, without a change in status in the investment (e.g. an increase in the investor's ownership interest from 20% to 25% while maintaining significant influence).

Transactions with equity-accounted investees

58 IAS 28 provides guidance on various types of transactions between an investor and its associate or joint venture. As a general principle, IAS 28 requires 'unrealised' profits and losses on transactions with equity-accounted investees to be eliminated to the extent of the investor's interest in the investee except in the specific circumstance set out in paragraph 31 of IAS 28.

59 However, the Standard lacks guidance on various aspects of the accounting for transactions with investees. This has created uncertainty in the way the equity method should be applied to some transactions between an investor and its investee and has led to diversity in practice.

Measurement basis

60 If the equity method were considered to be a pure measurement basis – on the premise that the investment is a single unit of account that is measured using the equity method – then it could also be argued that a transaction between an investor and its non-controlled investee should be accounted for similar to any other transaction with a third party. Therefore an entity would recognise profits and losses on transactions arising from transactions with equity-accounted investees in full in profit or loss.

61 In case of a sale or a contribution of an asset the investor would derecognise the underlying asset, and recognise the full gain or loss on the sale or contribution under applicable IFRS (for example under IAS 16 *Property, Plant and Equipment*). In the same way, an investor's share of gains and losses on 'upstream' and 'downstream' transactions would be recognised in full.

62 It could also be argued that there is no need to differentiate between 'realised' and 'unrealised' gains and losses that arise on transactions with equity-accounted investees. In principle, the 'realisation' of such a gain or loss is not dependant on the future cash flows of the underlying investee and hence the earnings process is considered complete. A loss would be recognised based on the impairment requirements of applicable IFRS.

63 One of the practical advantages of immediate recognition of a gain or loss is that it is simple to do. For example, there is no need to track the 'unrealised' gains and losses and determine when these should be recognised in profit or loss. There is also no need to decide whether the item sold or contributed, on which a gain or loss was made, meets the definition of a business.

64 The investor should however be required to disclose information on gains or losses arising from transactions with its associates or joint ventures. Such related-party transaction information would be useful to users of financial statements.

One-line consolidation

65 The key principle would be to require gains and losses on all transactions with equity-accounted investees to be eliminated to the extent of the investor's interest in the investee.

Share of other net asset changes

66 Such changes include those arising from movements in the share capital of the investee (e.g. when the investee issues additional shares to third parties or buys back shares from third parties) and movements in other components of the investee's equity (e.g. when an investee accounts for an equity settled share-based payment transaction).

67 However further work would be needed to better understand the economic substance of such transactions and particularly the rights to benefits, if any, in the form of future cash flows and obligations for liabilities, if any, they may bring to an investor. The views below reflect some initial thoughts on the accounting outcomes under the equity method.

Measurement basis

68 If the net assets in the investee increase (as a result of the other net asset changes), it could be argued that the increase should not be recognised by an investor. In principle, an investor has not paid anything to increase its investment so there is nothing to recognise.

69 Another view might be to consider whether an investor will benefit from future economic benefits from the transaction undertaken by the investee. If it will, the future benefits (for example in the form of additional cash flows) should be reflected by the investor in the amount of the investment it holds. However any increase in value should be recognised in either profit or loss or other comprehensive income as the investee is not part of the group; therefore transactions involving the investee, directly or indirectly, should not be accounted for in equity.

70 Changes in other net assets that result in decreases in future cash flows should be reflected by recognising an impairment loss on the investment. This would be recognised in profit or loss in accordance with applicable IFRS.

One-line consolidation

71 One view might be to consider whether an investor will benefit from future economic benefits from the transaction. If it will, the future cash flows should be reflected in the amount of the investment. In principle, the amount should not be recognised in equity given that neither an associate nor a joint venture are part of the group as defined in IFRS.

72 Decreases in future cash flows should be reflected by recognising an impairment loss on the investment. This would be recognised in profit or loss in accordance with applicable IFRS.

OTHER PERSPECTIVES ON THE EQUITY METHOD

73 The analysis above implicitly assumes that the equity method is either a one-line consolidation or a measurement basis. However these are not the only ways in which one could look at the equity method. For example, it would be possible to view the equity method in one of the following ways:

(a) *Equity method as a hybrid approach* – This view regards the equity method as an approach that has characteristics of both a one-line consolidation and a measurement basis. Depending on the nature of the transaction or event, the equity method could prescribe a treatment that was either closely aligned to the one approach or the other.

(b) *Equity method as a one-line consolidation based on a proprietary perspective* – Even if the equity method is regarded as a form of one-line consolidation, it is not necessary that the consolidation procedures applied are aligned with those required by IFRS 10, which is based on the entity concept. Instead, given the different nature of investments in associates and joint ventures, the use of consolidation procedures based on a proprietary perspective might be more appropriate and relevant.

It should be noted that the above list is not exhaustive and that further perspectives may exist.

SUMMARY

74 The historical development of the equity method was that of a one-line consolidation, reflecting the results of subsidiaries in the financial statements of a parent entity in a time before consolidation had evolved, and when not all controlled companies were consolidated.

75 However the recent thinking of the IASB when developing IFRS 3, IFRS 10 and IFRS 11 emphasises the concept of 'exclusive control' in the context of acquiring control and losing control to determine the boundary of a reporting entity and of its assets and liabilities and their consequential accounting. Neither an associate nor a joint venture are controlled by an investor, and are therefore not part of the group under IFRS. For these reasons, it could be argued that the equity method cannot conceptually be a one-line consolidation.

76 As a basis to portray performance of an investment in an associate or a joint venture, some would conclude that the equity method is arguably superior in terms of relevance of information provided by both cost and fair value, for the same reasons these came to be considered inappropriate for holding company financial statements before consolidation. Proponents of this view are likely to believe there are valid arguments to maintain the equity method as a means to account for interests in associates and joint ventures.

77 A wider agreement on the conceptual underpinnings of the equity method will contribute to improving the quality of financial reporting and assist the standard setting process.

Questions to constituents

We would welcome views, sent to commentletters@efrag.org by 15 May 2014, on any of the points addressed in this paper. In particular:

78 **Do you view the equity method under IAS 28 as a measurement basis, a one-line consolidation approach or something different? Please explain.**

79 **If you view the equity method under IAS 28 as being akin to a one-line consolidation approach, do you believe that the consolidation procedures should be based on the entity concept in IFRS 10 or not (e.g. based on a proprietary approach)? Please explain.**

80 **Do you think that for some transactions a measurement basis appropriately reflects the underlying economics of the transaction and provides useful information, whilst for other transactions a one-line consolidation approach is preferable? Could you provide some examples of transactions where application of either of the concepts would be more appropriate?**

81 **Have you had practical problems in applying IAS 28, because the underlying nature of the equity method is unclear? If so, could you please describe those problems and how you addressed them?**

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