EFRAG
European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 30 January 2014 to commentletters@efrag.org

9 January 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 welcomes the proposed amendments to IAS 27 *Separate Financial Statements* to allow the use of the equity method to account for investments in subsidiaries, joint ventures and associates in an entity's separate financial statements.

EFRAG is generally not in favour of introducing accounting policy options in IFRS, as it reduces the comparability of financial information. However, we believe that this is outweighed by the benefits of better aligning the accounting principles applicable to different sets of financial statements, even though such benefits may be mitigated by divergences resulting from the interaction of IAS 27 and IAS 28 with other standards.

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) paragraph C5 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* should be amended to extend the exemption for past business combinations and past acquisitions of investments in associates and joint ventures to cover subsidiaries, including those that were not acquired, and to consider specifically the treatment of such relief in the separate financial statements; 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?

Notes to constituents

1 *In the 2011 Agenda Consultation the IASB received requests to reinstate the use of the equity method in separate financial statements. This option had been removed with the revision of IAS 27 and IAS 28 in 2003. At the time, the IASB noted that the information provided by the equity method was already reflected in consolidated and other financial statements in which investments are accounted for under IAS 28, and that there was no need to provide the same information in separate financial statements.*

2 *The exposure draft proposes changes to both definition and preparation requirements of separate financial statements in IAS 27. With the proposed amendments to paragraph 10 of IAS 27 an entity may opt to account for investments in subsidiaries, joint ventures and associates either at cost, in accordance with IAS 39 or using the equity method as described in IAS 28. Still, an entity will have to apply the same accounting for each category of investments.*

3 *Paragraph BC10 of the ED notes that if an entity applies the equity method to account for its investments in subsidiaries in separate financial statements, there can be situations where the investor's net assets and profit or loss would not be the same in separate and consolidated financial statements. The ED mentions one example related to impairment testing of goodwill vs. impairment testing of an investment accounted for under the equity method. However, 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.*

EFRAG's response

EFRAG is generally not in favour of introducing accounting policy options in IFRS, as it reduces the comparability of financial information. However, we believe that this is outweighed by the benefits of better aligning the accounting principles applicable to different sets of financial statements, even though such benefits may be mitigated by divergences resulting from the interaction of IAS 27 and IAS 28 with other standards.

Use of the equity method in separate financial statements

4 EFRAG supports the proposed amendments to IAS 27 *Separate Financial Statements* to allow the use of the equity method to account for investments in subsidiaries, joint ventures and associates in an entity's separate financial statements.

5 EFRAG is generally not in favour of introducing accounting policy options in IFRS, as it reduces the comparability of financial information. However, we believe that this is outweighed by the following benefits:

(a) *Subsidiaries* – Aligning better the accounting principles applicable to the separate financial statements under IFRS with those applicable to the statutory financial statements (which may already require use of the equity method); and

(b) *Associates and joint ventures* – Aligning better the accounting principles applicable to the separate financial statements under IFRS with those applicable to the consolidated financial statements (which already require use of the equity method) and the statutory financial statements (which may already require use of the equity method).

6 In addition, EFRAG agrees with the IASB that the equity method can provide useful financial information about the investors' net assets and profit or loss, both in separate and consolidated financial statements.

Application of the equity method to investments in subsidiaries

7 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.

8 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

9 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.

10 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 to constituents

11 Do you consider that adding the equity method option in separate financial statements will result in cost savings for preparers? Please explain.

12 Does the application of the equity method to subsidiaries in the separate financial statements give rise to any issues that are not identified above? Please explain.

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?

Notes to constituents

13 *The IASB proposes retrospective application of the proposed amendments to entities already applying IFRS.*

14 *As referred to in paragraph BC12 of the ED, the IASB considered that a parent should be able to use the information gathered for the consolidation of a subsidiary to apply the equity method retrospectively in separate financial statements.*

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.

15 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.

16 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 8 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.

17 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?

Notes to constituents

18 *The IASB does not propose any amendment to IFRS 1 to provide relief to first-time adopters that elect the use of the equity method in the separate financial statements.*

EFRAG's response

EFRAG believes that for first-time adopters paragraph C5 of IFRS 1 should be amended to extend the exemption for past business combinations and past acquisitions of investments in associates and joint ventures to cover subsidiaries, including those that were not acquired, and to consider specifically the treatment of such relief in the separate IFRS financial statements.

19 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.

20 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.

21 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. However, we believe that the wording of paragraph C5 of IFRS 1 should be amended to extend the relief to cover subsidiaries, including those that were not acquired, and to consider specifically the treatment of such relief in separate financial statements.

22 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?

Notes to constituents

23 *According to paragraphs 24 and 25 of IAS 28, if an entity's ownership interest in an associate or a joint venture is reduced but the investor continues to apply the equity method, the entity recognises part of the other comprehensive income in profit or loss and does not remeasure the retained interest.*

24 *In paragraph BC11 of the ED the IASB noted that such an accounting treatment when applied to the loss of control of a subsidiary was not in accordance with the principles of IFRS 10, that require an entity to recognise any investment retained in a former subsidiary at its fair value when control is lost, and therefore proposed an amendment to paragraph IAS 28 in order to avoid any conflict in the accounting on the loss of control of subsidiary.*

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.

25 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.

26 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%).

27 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; and

(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.

28 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?

29 We have no other comments.

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

Notes to constituents

30 EFRAG expects to publish a consultation paper on the nature of the equity method in January 2014. That paper will be attached to EFRAG's final comment letter.