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Equity Method of Accounting Cover Note

Objective

- 1 The objective of the session is to:
 - (a) provide EFRAG CFSS and TEG members with an update on the IASB Research Project *Equity method (the Project)*; and
 - (b) seek EFRAG CFSS and TEG members' views on
 - (i) application questions that have recurrent themes but are outside the scope of the Project;
 - (ii) the alternatives for addressing the application questions on changes in an investor's interest in an associate without change in significant influence; and
 - (iii) the Short Paper Series No. 3 of ASBJ *Perspectives of Equity Method of Accounting* and related ASBJ presentation.

Background of the IASB Project

- 2 Following its Feedback Statement to the 2011 Agenda Consultation, the IASB decided to add the project on equity method of accounting to the research programme. The IASB justified its decision using the feedback from constituents what included the criticisms related to application of the equity method, its complexities, and inconsistencies. The research was intended to involve a fundamental assessment of the equity method in terms of usefulness and difficulties for preparers.

Post-implementation review of Consolidation Package

- 3 At its May 2016 meeting, however, the IASB decided to defer the work on the Project until the post-implementation review of IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities (the PIR)*. Following the feedback from the PIR on the investors' information needs, the IASB would reconsider the scope of the Project.
- 4 The EFRAG Secretariat notes that IFRS 11, covered by the PIR, does not provide guidance on the equity method. Consequently, in its response to the IASB's Request for Information on the PIR, EFRAG pointed out that the PIR should also have included the revision of IAS 28 and, moreover, EFRAG listed several most important issues related to lacking guidance, and inconsistencies with other IFRS Standards, of IAS 28 requirements. EFRAG's response to the PIR is available on [EFRAG's web site](#).
- 5 The feedback of the PIR that relates to equity method of accounting was summarised at the IASB meeting in June 2021 as follows:

Some respondents said there are practical issues in applying the equity method in accordance with IAS 28. Respondents hold different views on how to address practical issues; some suggest a fundamental review of the use of the equity method, others support the Board focuses on resolving application issues without a fundamental change. (Ref.: [ap7b-analysis-of-feedback-ifs-11-ifs-12-and-other](#), IASB Agenda Paper AP7B - July 2021 IASB meeting)

Recent developments

- 6 In October 2020 meeting, the IASB reconsidered the scope of Project, and decided that the objective of this research is to:
- Assess whether application questions with the equity method, as set out in IAS 28, can be addressed in consolidated and individual financial statements by identifying and explaining principles in IAS 28.*
- 7 In order to achieve this, the IASB decided to apply the following approach which would involve:
- (a) identifying application questions and deciding which of these questions to address; and
 - (b) addressing the application questions by identifying and explaining the principles in IAS 28.
- 8 In order to be further considered by the IASB, the application questions would need to be not-yet-solved, possible to solve without fundamentally rewriting IAS 28; possible to solve without amending other IFRS Standards; important (i.e., frequent, widespread, material) and affecting consistent application of IAS 28.
- 9 The selection criteria would also mean that the IASB would not consider fundamental reconsidering of IAS 28 guidance, what may exclude some of the application issues from the scope of the Project.

Questions for EFRAG CFSS and TEG members

- 10 Do you have a comment on the IASB's approach to the Project?

Identified Principles

- 11 In June 2021, the following principles, identified by the IASB Staff as underlying IAS 28, were presented to the IASB:
- (a) Principle A — power to participate is an investor's shared power to affect changes in, and to access net assets;
 - (b) Principle B — application of the equity method includes an investor's share in the associate's or joint venture's net asset changes in an investor's statement of financial position;
 - (c) Principle C — an investor's share of an associate's or joint venture's net assets is part of the reporting entity;
 - (d) Principle D — fair value at the date that significant influence or joint control is obtained provides the most relevant information and faithful representation of an associate's or joint venture's identifiable net assets;
 - (e) Principle E — an investor recognises changes in an associate's or joint venture's net assets. An investor recognises the share of changes in net assets that it can currently access;
 - (f) Principle F — an investor's maximum exposure is the gross interest in an associate or joint venture;

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- (g) Principle G — when an investor has a decrease in its ownership interest in an associate or joint venture and continues to apply the equity method, it reclassifies amounts previously recognised in other comprehensive income;
 - (h) Principle H — an investor:
 - (i) applies IFRS 3 and IFRS 10 if it obtains control of an associate or joint venture;
 - (ii) applies IFRS 9 if it no longer has significant influence or joint control but retains an interest in a former associate or joint venture; and
 - (iii) recognises a gain or loss and reclassifies amounts recognised in other comprehensive income on the date that significant influence or joint control is lost.
- 12 The above list should not be considered complete but it's rather a list of principles related to the scope of the Project. Furthermore, these principles are intended to be used by the IASB as a toolbox to develop new requirements rather than to be incorporated in IAS 28.
- 13 For background purposes, the details of discussion regarding principles, identified in IAS 28, their source, and the IFRS guidance where they were derived from, are provided in **Agenda Paper 06.03** - this Agenda Paper was discussed by the IASB at its June 2021 meeting, and is also provided for the October 2021 ASAF meeting.

Examples of the Application Issues

- 14 Initially the IASB Staff collected 22 application issues /questions from the past IFRS Interpretations Committee's agendas and IASB discussions, other constituents' research and comments. Furthermore, 49 potential questions were added following the discussions with national standard setters, accounting firms, and regulators. Following the application of selection criteria, a short list of issues/questions were selected.
- 15 This list of selected example issues/questions are provided in **Agenda Paper 06.03**. These issues could be considered by the IASB in the future:

Re: Principle B

- (a) where should an investor report its share of changes in the investee's net assets that are not recognised in profit or loss or other comprehensive income of the investee, and that are not distributions received
- (b) application of paragraph 35 of IAS 28 when there are regulatory restrictions on the use of an associate's financial information, or an investor does not have sufficient details to align the associate's accounting policies

Re: Principle C

- (c) the treatment of reciprocal interests, or crossholdings. These occur when an associate or joint venturer owns an interest in an investor, or another associate. The application question concerns how the investor should determine its own and the other investors' interests in the associate;
- (d) the accounting for the elimination of the portion of an investor's gain that exceeds the carrying amount of the net interest in the associate or joint venture.

Re: Principle D

- (e) the measurement of the cost of an associate or joint venture in a step acquisition;

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- (f) whether the differences between the fair value of an associate's identifiable assets and liabilities and their tax bases in the associate's financial statements give rise to temporary differences in accordance with IAS 12 Income Taxes;
- (g) whether any goodwill recognised in an investee's financial statements is part of the investee's identifiable assets. This inclusion would not affect the initial measurement of the interest, but it may affect the subsequent measurement if the investee subsequently disposes of the business that the goodwill is associated with or impairs the goodwill,

Re: Principle E

- (h) the factors an investor considers when determining the amount of its share of changes in the investee's net assets
- (i) how to determine the investor's share of net asset changes if financial instruments provide different access to the investee's returns over the life of the investee or at liquidation
- (j) the application of paragraph 34 of IAS 28 when the investor does not have access to the investee's financial information in a timely manner

Re: Principle F

- (k) the investor purchases an additional interest in the associate or joint venture
- (l) the associate or joint venture subsequently reports a loss and a positive change in other comprehensive income in the same period (or the other way around)
- (m) the investor realises a gain in a "downstream" transaction with the associate or joint venture

Re: Principle G

- (n) the treatment of dilution gains or losses.

Areas where IAS 28 Lacks Guidance

- 16 Furthermore, the following example areas, where IAS 28 lacks guidance and consequently principles, have been identified:
- (a) the investor's accounting for the share in the investee's other net asset changes; and
 - (b) purchases or other increases in the investor's ownership share that do not result in obtaining control of the investee.

Next steps in the IASB project

- 17 At future meetings, the IASB plans to discuss how to apply the principles, underlying IAS 28, in response to specific application questions or to address the areas where IAS 28 lacks guidance for which the IASB plans to develop the missing principles. The summary of the discussion is provided in **Agenda Paper 06.01a Issues paper**.
- 18 The details of the IASB Staff analysis are provided in **Agenda Paper 06.05 Issues paper**, which is uploaded as a background paper for this meeting.
- 19 Moreover, the IASB Staff has excluded some issues that have recurrent themes. The summary of the discussion whether these issues warrant extending the scope of the project is provided in **Agenda Paper 06.01a Issues paper**. The details of the discussion are provided in **Agenda Paper 06.04**. This paper is uploaded as a background paper for this meeting.

EFRAG discussions

- 20 In January 2014, EFRAG published a Discussion Paper *The Equity Method: A Measurement Basis or One-line Consolidation?* The objective of the Discussion

Paper was to debate the nature of the equity method, that is whether it is a one-line consolidation or a measurement method (or possibly a hybrid). In the Discussion Paper, EFRAG noted that one argument against the equity method as a one-line consolidation is that control is the basis for consolidation in IFRS 10, and joint ventures and associates are not controlled by an investor. Responses to the Discussion Paper showed a diversity of views, indicating that there is no common understanding of the purpose or use of the equity method.

- 21 This Discussion Paper is available on [EFRAG's web site](#).
- 22 EFRAG has not discussed topics related to the IASB project following its reactivation in October 2020.

Issues for EFRAG CFSS and TEG members' discussion

- 23 **Agenda Paper 06-01a Issues Paper** provides a source for the discussion on several topics, where the EFRAG Secretariat seeks input from EFRAG CFSS and TEG members. The topics relate to the areas excluded from the scope of the Project, proposed alternatives for the solution of one area of application issues/questions, and the discussion of the ASBJ regarding whether the equity method of accounting should be considered as one-line consolidation technique, or rather measurement technique. The paper contains the following:

Questions for EFRAG CFSS and TEG members

- 24 What are the views of EFRAG CFSS and TEG members on application questions that have recurrent themes but have been excluded from the project in applying the selection process?
- 25 What are the views of EFRAG CFSS and TEG members on Alternatives 1 to 4 and their implications for the accounting for changes in the investor's interest in an associate without a change in significant influence?
- 26 Do you agree that the equity method of accounting should adopt a hybrid approach? Why or why not?
- 27 Do you have any comments on the principles proposed by ASBJ?

Agenda Papers

- 28 In addition to this cover note, the following **ASAF agenda papers** are provided as **background papers** for this session:
 - (a) Agenda paper 06-01a – Issues Paper
 - (b) Agenda paper 06-02 – ASAF Agenda Paper AP1 - For background;
 - (c) Agenda paper 06-03 – ASAF Agenda Paper AP1A - For background;
 - (d) Agenda paper 06-04 – ASAF Agenda Paper AP1B - For background;
 - (e) Agenda paper 06-05 – ASAF Agenda Paper AP1C - For background;
 - (f) Agenda paper 06-06 – ASAF Agenda Paper AP1D – ASBJ paper: Perspectives on the Equity Method of Accounting - For background; and
 - (g) Agenda paper 06-07 – ASAF Agenda Paper AP1E - ASBJ presentation - For background.