EFRAG Secretariat: Didrik Thrane-Nielsen (Project Director), Robert Stojek

Equity Method of Accounting
Issues Paper

Objective

1 The objective of the session is to:

(a) provide EFRAG FR TEG and CFSS members with an update on the IASB Research Project *Equity Method* (***the Project***); and

(b) seek EFRAG FR TEG and CFSS members' views on accounting for transactions between an investor and its associate.

Background and history of the IASB Project

2 Following the Feedback Statement to the 2011 Agenda Consultation, the IASB decided to add a 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.

3 In October 2020, the IASB reconsidered the scope of project and decided that its objective 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.*

4 Accordingly, the IASB decided not to fundamentally reconsider IAS 28 guidance. Consequently, some of the application issues would be excluded from the scope of *the Project*.

5 In Appendix 1, we provide the list of identified principles underlying IAS 28 requirements.

6 In Appendix 2, we provide a short list of issues/questions that satisfied the following IASB Staff selection criteria: whether application questions were not-yet-solved, possible to solve without fundamentally rewriting IAS 28, possible to solve without amending other IFRS Standards, and important (that is frequent, widespread, material, and affecting consistent application of IAS 28).

Recent discussion and tentative decisions of the IASB

April 2022

7 The IASB tentatively decided to consult through an exposure draft or a discussion paper on measuring the cost of an investment, when an investor obtains significant influence, as the fair value of the consideration transferred, including the fair value of any previously held interest in the investee.

8 The IASB decided to continue the project and to consider:

(a) **a preferred approach** whereby an investor, after obtaining significant influence, would measure the investment in the associate as an accumulation of purchases; and

(b) **an alternative approach** whereby an investor would measure the investment as a single asset at its fair value at the date of the purchase of an additional interest.

9 Nevertheless, the IASB instructed its stuff to consider the preferred approach in the further steps of the project in their research and analyses.

June 2022

10 The IASB tentatively decided that:

(a) an investor applying the preferred approach to a bargain purchase of an additional interest, while retaining significant influence, would recognise a bargain purchase gain in profit or loss.

(b) an investor applying the preferred approach to a partial disposal, while retaining significant influence, would measure the portion of the carrying amount of an investment in an associate to be derecognised using:

(i) a specific identification method, if the investor can identify the specific portion of the investment being disposed of and its cost; and

(ii) the last-in, first-out method, if the specific portion of the investment being disposed of cannot be identified.

September 2022

11 The IASB tentatively decided that:

(a) when the investor's ownership interest increases and retains significant influence, an investor applying the preferred approach would recognise that increase as a purchase of an additional interest.

(b) when the investor's ownership interest decreases and retains significant influence, an investor applying the preferred approach would recognise that decrease as a partial disposal.

12 The transactions that change an investor's interest include transactions in which:

(a) the investor exchanges consideration with the associate, for example an investor being the sole party subscribing to newly issued shares in the associate;

(b) the investor buys a greater or smaller proportion of the newly issued shares offered than its pre-transaction proportionate ownership interest); or

(c) the investor does not exchange consideration with the associate, other parties subscribe for the new shares issued by the associate and therefore, the investor's ownership interest decreases – consequently, the investor's position is changed as its ownership interest decreases as does its share in the associate's net assets.

13 These decision does not apply to an associate's equity-settled share-based payment transactions that result in the associate issuing new shares to the counterparty and changing the investor's ownership interest. This will be discussed by the IASB in future meetings.

14 It should also be noted that not all transactions that change the associate's net assets also change the investor's ownership interest. For instance, if all existing shareholders take part in an associate's share issue or redemption in proportion to their current ownership interests, the associate's net assets change, but the investor's ownership is unchanged.

15 Furthermore, not all changes in an investor's ownership share change an associate's net assets. This are purchases or disposals of shares between investors, which do not change an associate's net assets, or equity-settled share-based payments, where in the vesting period the associate recognises an expense in profit or loss and increases equity for an amount corresponding to the expense.

Next steps in the IASB project

16 In September 2022, the IASB started its discussion on application issues resulting from transactions between the investor and its associate.

17 The issue that is now being considered refers to the acknowledged inconsistency between the requirements of IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*.

18 The IASB seeks input regarding the existing approaches in various jurisdictions. It has already discussed the topic at the Global Preparers Forum and plans a discussion at the coming ASAF meeting in December 2022.

19 The details of the issue are presented in the further section of this paper – ***Issues to be considered***.

Issues to be considered

20 Following the finalisation of discussion on application issues arising from a change of investor's interest in an associate, the IASB commenced its discussion regarding accounting for transactions between an investor and its associate.

21 Originally, the IASB Staff identified the following application issues/questions that satisfied the selection criteria mentioned in paragraph 6 above:

(a) How should an investor account for gains and losses that arise from the sale of a subsidiary to its associate, applying the requirements of IFRS 10 and IAS 28?

(b) In a downstream transaction, whether an investor recognises its share of a gain that exceeds the carrying amount of its investment in the associate?

(c) In an upstream transaction, whether an investor eliminates its share of gain or loss from the carrying amount of the investment in the associate or the acquired asset?

(d) Are the provision of service and transactions, that are not transfer of assets, subject to the requirements for upstream or downstream transactions?

22 The issues in paragraphs 21(b) to 21(d) will be discussed by the IASB in future meetings.

Scope of the issue and the reasons

23 The accounting for following groups of transactions is considered:

(a) contributions (or sales) of a subsidiary to an associate in exchange for an equity interest in that associate (and/or cash consideration); and

(b) contributions (or sales) of assets that are not housed in a subsidiary to an associate.

In that respect:

(a) all the contributions/sales analysed in this paper result in the **loss of control** of the subsidiary or assets contributed/sold.

(b) the subsidiary or the assets contributed/sold **may or may not** constitute a business.

(c) the entity that makes the contribution/sale may retain significant influence over the interest in the former subsidiary or the assets contributed/sold.

24 In regard to accounting for such transaction in consolidated financial statements, there is an acknowledged inconsistency between the requirements of IFRS 10 and IAS 28 for the sale of a subsidiary to an investor's associate. The inconsistency arises because:

(a) 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, if any, at fair value; whereas

(b) 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 reduces the gain for its related interest (elimination entries).

History of the discussion

25 The IASB discussed this inconsistency in 2014 and initially issued amendments to IFRS 10 and IAS 28. The amendments required recognising:

(a) a full gain or loss when a transaction involves a business (whether it is housed in a subsidiary or not), and

(b) a partial gain or loss when a transaction involves assets that do not constitute a business, even if these assets are housed in a subsidiary.

26 However, following its discussions with the IFRS Interpretations Committee in June 2015, they decided that other issues with respect to the sale or contribution of assets between an investor and its associate should be addressed as part of its research project on equity accounting. Consequently, in December 2015, the IASB **indefinitely deferred the effective date** of the amendments.

Current discussion

27 The IASB Staff analysed four alternative approaches based on:

(a) principle C (see Appendix 1) which states that the reporting entity is extended to include the investor's share of the associate's net assets and is derived from paragraph 28 of IAS 28; and

(b) the changes made to IFRS Accounting Standards arising from the *Conceptual Framework for Financial Reporting* (Conceptual Framework), *Business Combinations*, *Consolidations and Joint Arrangements* projects, and particularly the boundary of a reporting entity and the economic entity perspective.

28 The IASB initially considered the following four alternative approaches (reproduced from the IASB Staff paper).

<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[12]</td><td>Ordinary activities[13]</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)[14]</td><td>Unclear[15]</td><td>Many towards policy choice (full/partial)[16]</td><td colspan="2">Partial[17]</td></tr>
</table>

Alternative 1

29 This is the most robust alternative. It requires an investor that loses control of a subsidiary (or assets) to measure the consideration received at fair value, including any investment retained in the former subsidiary and recognise a full gain or loss irrespective of whether:

(a) the subsidiary or the assets constitute a business; or

(b) the assets are housed in a subsidiary.

30 Consequently, no elimination entries' requirements apply.

31 Applying this approach would be a move away from the traditional view that the equity method is a one-line consolidation method.

Alternative 2

32 Under this approach, the requirements of IFRS 10 and IAS 28 are both applied to the transaction and are not treated as inconsistent. An investor:

(a) would apply the loss of control requirements in IFRS 10 (by recognising a full gain or loss and measuring any investment retained in the former subsidiary at fair value); and

(b) would overlay with the elimination entries' requirements in IAS 28 by restricting the gain or loss to the extent of the unrelated investor's interests in the associate.

33 This approach retains the elimination entries' requirements.

34 In the existing guidance, in accordance with paragraph 30 of IAS 28, the overlay approach is used for the derecognition of an asset, but it is not used for the derecognition of a business. This approach eliminates this inconsistency and proposes to apply the overlay approach to both types of transactions.

35 This approach seems to be more complex compared to Alternative 1.

36 A disadvantage of this approach is that the preparers may face difficulties in obtaining information required for the elimination entries, particularly in a contribution that constitutes a business. However, this approach describes the mechanics between IFRS 10 and IAS 28 without compromising the rationale that underlies the Business Combination project and the Consolidations project that is,

the loss of control is a significant economic event for which it leads to full recognition of gains and losses.

Alternative 3

37 Under this approach:

(a) when an investor loses control (or derecognises) an asset that is not an output of its ordinary activities, the gain or loss recognised would not be restricted to the extent of the unrelated investors' interests in an associate:

(i) whether the asset constitutes a business or not; and

(ii) whether the asset is housed in a subsidiary or not.

(b) the elimination entries' requirements would retain for the transactions involving assets that are an output of an investor's ordinary activities (in the scope of IFRS 15 *Revenue from Contracts with Customers*), so that the gain or loss recognised would be restricted to the extent of the unrelated investors' interests in an associate.

38 This approach, compared to Approach 1 and 2, considers whether a transaction is a part of ordinary activities (IFRS 15) or not and, depending on assessment, requires applying the elimination entries.

39 It should be noted that this approach is consistent with US GAAP Accounting Standards Codification 610-20 *Other Income–Gain and Losses from the Derecognition of Nonfinancial Assets*.

Alternative 4

40 Finally, this approach retires the elimination entries' requirements for contributions of assets that do not constitute a business. Consequently,

(a) the full gain or loss is recognised when a transaction involves a business (whether it is housed in a subsidiary or not); and

(b) the partial gain or loss is recognised when a transaction involves assets that do not constitute a business, even if these assets are housed in a subsidiary.

41 Under this approach, a line between what constitutes a business versus a collection of assets needs to be drawn, what requires significant judgement. Consequently, introducing another accounting difference, when it comes to derecognition and loss of control, that is dependent on the interpretation and exercising judgement of the definition of a business may lead to unduly complexities.

42 However, this approach would only require amending the 2014 amendments, what seemed to be efficient for standard setting purposes.

Questions for EFRAG FR TEG and CFSS members

43 Do you have questions or comments on the update on the IASB's project on Equity Method

44 What are your views on the four alternatives presented above? Please explain the rationale for your view.

45 Which alternative, do you think, provides a faithful representation of the transactions scoped in paragraph 23 above?

Agenda Papers

46 In addition to this issues paper, the following papers have been included for the session:

(a) **Agenda Paper 10-02** – Equity method – The IASB Staff paper – Agenda Paper 6 for coming ASAF meeting (for background purposes.);

(b) **Agenda Paper 10-03** – Equity method – The IASB Staff presentation – Agenda Paper 6A for coming ASAF meeting (for background purposes.);

(c) **Agenda Paper 10-04** – Equity method: Transactions between an investor and its associate - an acknowledged inconsistency between the requirements of IFRS 10 *Consolidated Financial Statements* and IAS 28 – The IASB Staff paper – Agenda Paper 6B for coming ASAF meeting (for background purposes).

Appendix 1. Identified Principles Underlying IAS 28

In June 2021, the following principles, identified by the IASB Staff as underlying IAS 28, were presented to the IASB:

Classification

(a) Principle A — power to participate is an investor's shared power to affect changes in, and to access net assets.

Boundary of the reporting entity

(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.

Measurement on initial recognition

(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.

Subsequent measurement

(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.

(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.

Derecognition

(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.

The above list should not be considered complete but it's rather a list of principles related to the scope of the Project. For example, some principles related to the presentation have also been identified. The principles, mentioned above, are intended to be used by the IASB as a toolbox to develop new requirements rather than to be incorporated in IAS 28.

Appendix 2. List of application issues/questions for the IASB discussion

The following is the list of application questions within the scope of the project to be considered by the IASB in future meetings.

Changes in an investor's interest while retaining significant influence

1 How does an investor apply the equity method when disposing of an interest in an associate while retaining significant influence?

2 Whether an investor recognises its share of other changes in an associate's net assets, and if so, how is the change presented?

Recognition of losses

3 Whether an investor that has reduced its interest in an investee to nil is required to 'catch up' unrecognised losses if it purchases an additional interest in the investee?

4 Whether an investor that has reduced its interest in an investee to nil continues eliminating its share of gains arising from a downstream transaction?

5 Whether an investor that has reduced its interest in an investee to nil recognises each component of comprehensive income separately?

6 For example, in a financial year, an investee recognises a loss in comprehensive income that includes, a profit in its statement of profit and loss, and a loss in its statement of other comprehensive income

Transactions between investor and associate

7 Whether to recognise the portion of the investor's share of gain that exceeds the carrying amount of its investment in the investee in a downstream transaction?

8 Whether the investor's share of gain or loss is eliminated from the carrying amount of the investment in the investee or the acquired asset in an upstream transaction?

9 Whether the provision of service and transactions that are not transfer of assets are upstream or downstream transaction?

10 How should an investor account for gains and losses that arise from the sale of a subsidiary to an investee given the requirements of IFRS 10 Consolidated Financial Statement and IAS 28?

11 In a transaction where an investor sells a subsidiary to its investee, paragraph 25 of IFRS 10 requires the investor to recognise in full the gain or loss from the sale of a subsidiary, remeasuring any retained interest whereas paragraph 28 of IAS 28 requires an investor to eliminate the gain or loss to the extent of the retained interest in the former subsidiary.

Transactions between two associates

12 Whether the requirement for adjustment of gains and losses in intra-group transactions between subsidiaries should be applied by analogy to transactions between investees that are accounted for applying the equity method?

Impairment

13 Whether the decline in fair value is assessed in relation to the original purchase price or the carrying amount at the reporting date?

Initial recognition

14 Whether the investor recognises deferred tax assets and liabilities on the differences between the fair value and the tax base of its share of the investee's net assets?

Contingent consideration

15 How to initially and subsequently account for contingent consideration in the acquisition of an investee applying IAS 28?