Note by the Financial Reporting Standards Committee of the European Accounting Association in Response to EFRAG's 'Short Discussion' on the Equity Method (of January 2014)

We consider that EFRAG's paper is timely, and are pleased to see some reference to academic research. At the end of this note we suggest a few recent further papers which might be of interest. We would add we found the paper easy to read and well explained.

We reply below to the four questions posed by the EFRAG paper, using its numbering system.

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

This question is somewhat ambiguous. It could mean, *inter alia*: (a) do we think that the equity method was designed by the IASC (and inherited by the IASB) as a measurement or as a consolidation approach?, (b) do we think that companies use (or users interpret) the equity method as measurement or consolidation?, (c) do we think that the equity method should now be considered by the IASB to be measurement or consolidation?

If we read the question as (a), then our answer is as follows. Our reading of the international history of the equity method (e.g. as in the paper by Nobes (2002), to which EFRAG refers) is that different members of the IASC would probably have had different answers. For example, the Dutch delegation probably thought that it was measurement whereas the US delegation probably thought that it was quasi-consolidation.

There is no clear articulation of the rationale for the equity method in the original or subsequent versions of IAS 28. The first version of IAS 28 to have a 'Basis for Conclusions' (BC) was that of 2003, but there is no discussion of the rationale in that or subsequent BCs.

If question 78 should be interpreted as in (b) above (i.e. preparers' or users' views), we expect a similar lack of consensus. There is little empirical research on the equity method. What there is (e.g. Comiskey and Mulford, 1986; Mazay *et al*., 1993) does not deal with this issue.

In terms of interpretation (c) above, we think that the IASB should now assess the equity method on the basis of whether it is a suitable measurement method not as a consolidation method, for the following reasons. First, the equity method does not entail any consolidation: the equity-accounted entity remains as a single line in the investor's balance sheet (either in its stand-alone balance sheet or in its consolidated one). Second, any form of consolidation would be inconsistent with the scope of the group as outlined in the ED on the Reporting Entity of 2010, with which we concur, and in IFRS 10. This is because these documents base consolidation on the existence of control.

A fortiori, we should also rule out equity accounting as a method of consolidation in the unconsolidated statements of an investor. This is of relevance for the IASB's ED of December 2013 on extending the use of the equity method.

Therefore, the IASB should assess the equity method on the basis of whether it is a suitable measurement method for investments. However, the vague concept of 'significant influence' is then irrelevant. Why should one measure an uncontrolled 30% investment differently from a 5% investment?

There is little academic research on whether the equity method is a sensible measurement basis. Tutticci (2002) finds some evidence that the equity method provides better information than that provided by cost, but is inconclusive about whether market values would be better. Graham *et al*. (2003) study associates that are listed, and conclude that there is no reason (in terms of useful information) to treat them differently from other listed investments, i.e. there is no reason not to use fair value for listed associates.

In our view, the equity method is likely to be better than cost because cost is such an uninformative basis for decision-making. However, if an associate is listed, then its fair value would be easier to establish and more intuitively appealing than the numbers derived from the equity method. If the associate is unlisted, then there might be questions about the verifiability of fair value, which might lead to the use of a rough-and-ready proxy. Even then, we do not see why the equity method should be preferred to the logic of IFRS 13. We note that the equity method is not mentioned as a possible measurement basis in the IASB's discussion paper of July 2013, and we can see why this is so.

If equity accounting is continued, and viewed as a measurement method, another interesting implication follows. In terms of IAS 39 (which we are still using in the EU), equity-accounted profits (except any part received as dividends) are akin to holding gains on available-for-sale investments not gains on trading investments. Therefore, equity-accounted profits should perhaps be recorded as other comprehensive income rather than as part of profit or loss.

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."*

Since we do not think that the equity method should be seen by the IASB as a form of consolidation, we do not reply to this question.

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?"*

We think that our answer to 78 (above) covers this question. We do not think that one-line consolidation is a meaningful concept, and we think that equity accounting is unlikely to be a good basis for measurement.

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?"*

We are not preparers of financial statements, so we cannot reply directly to this question. However, we note a number of conceptual difficulties posed by the equity method, including (a) whether (and how much) to eliminate profit on inter-company transactions, (b) whether the sale of shares such that an entity turns from a subsidiary to an associate is a discontinued operation, and (c) why an investor should recognise an associate's profits that have not been received and could not be successfully demanded.

These conceptual problems flow from the lack of a conceptual basis for the equity method.

References to empirical papers

Comiskey, E. and Mulford, C.W. (1986) 'Investment Decisions and the Equity Accounting Standard', *The Accounting Review*, Vol. 61, No. 3.

Graham Jr., Roger C., Lefanowicz, Craig E., Petroni, Kathy R. (2003) 'The Value Relevance of Equity Method Fair Value Disclosures', *Journal of Business Finance & Accounting*, Vol. 30, Issue 7/8.

Mazay, V., Wilkins, T. and Zimmer, I. (1993) 'Determinants of the Choice of Accounting for Investments in Associated Companies', *Contemporary Accounting Research*, Vol. 10, No. 1.

Tutticci, I. (2002) 'The Value Relevance of Equity Accounting in Australia during the Pre-recognition Regulatory Period', *Asia-Pacific Journal of Accounting and Economics*, Vol. 9, No. 2

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