European Financial Reporting Advisory Group

FEEDBACK STATEMENT

Responses to

EFRAG Short Discussion Series Paper

The equity method: a measurement basis or one-line consolidation?

This feedback statement has been prepared by the EFRAG staff for the convenience of constituents and represents a summary of responses received to the EFRAG Short Discussion Series Paper. It does not represent an expression of the views of EFRAG.

EFRAG
European Financial Reporting Advisory Group

Introduction

The EFRAG Short Discussion Series addresses topical and problematic financial reporting issues with the aim of stimulating debate among European constituents and beyond.

The equity method: a measurement basis or one-line consolidation? ('the EFRAG SDS Paper' or 'the paper') was published on 17 January 2014 and was the first paper in the EFRAG Short Discussion Series. Comments were requested by 15 May 2014.

Why was the paper written?

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*. The IASB has considered these requests by proposing narrow-scope amendments to IAS 28 with the aim of reducing diversity in practice.

When responding to two of the proposals to amend the equity method in IAS 28, EFRAG and other constituents expressed support for the IASB's efforts to address diversity but expressed concerns that the proposals lacked a clear conceptual basis and were potentially inconsistent with each other. It was noted that IAS 28 contains elements of both consolidation concepts and a measurement basis; however, it is not always clear which of the two concepts should be applied to situations and issues that are not specifically addressed in IAS 28.

In the context of making limited amendments to IAS 28, the paper explored whether the IASB characterising the equity method in a particular way could be helpful in having a basis upon which to solve the application issues that arise.

The paper did not call for a fundamental reassessment of the accounting for joint ventures or associates, but was intended to assist in the development of a clear set of principles underlying the equity method and contribute to the IASB's Research Project on this topic, as well as stimulate debate in Europe and beyond.

Responses from constituents

Nine comment letters were received in response to the EFRAG SDS Paper. A list of respondents is in the Appendix to this feedback statement. All comment letters received are available on the project page for the EFRAG SDS Paper on the EFRAG website.

Profile of responses by origin and type of respondent

By country/region of respondent	
Denmark	1
European Organisation	2
France	1
Germany	1
Japan	1
Norway	1
Spain	1
United Kingdom	1
	9

By type of respondent	
Academic Association	1
Accounting Association	1
Accounting/Audit Firm	1
Preparer Association	1
National Standard Setter	5
	9

Purpose and use of this feedback statement

This feedback statement has been prepared as a formal record of the responses received. It will be used by EFRAG as input for any future work on the equity method. It summarises the messages received from constituents and notes any key themes identified.

This feedback statement should be read in conjunction with the EFRAG SDS Paper, which is available on the EFRAG website

Questions asked in the EFRAG SDS Paper

The EFRAG SDS Paper asked four questions of constituents:

Q1 Do you view the equity method under IAS 28 as a measurement basis, a one-line consolidation approach or something different? Please explain.

Q2 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.

Q3 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?

Q4 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?

Executive Summary and key messages

Responses to the paper showed a diversity of views, indicating that there is no common understanding of the purpose or use of the equity method. [1]

There was limited consensus on whether the ideas explored in the paper could be used to clarify the equity method without a wholesale reassessment of its underlying role and some respondents specifically called for such a fundamental rethink. Other respondents thought that more clarity on underlying principles was needed, even if this would not be provided by explicitly identifying the equity method as either a one-line consolidation or a measurement basis.

Respondents believed that, when developing accounting requirements for investees that were jointly controlled or significantly influenced, the most important thing was providing relevant information to users of financial statements. It was not clear that any replacement for the equity method would provide sufficiently better information. In particular, the equity method was superior to cost because it provided earlier indication of the potential for dividend distribution and superior to fair value because of the potential for significant integration between the operations of investors and investees. The information provided by the equity method, including elimination of gains on transactions, was particularly relevant in such situations.

What was clear from respondents was that a view of the equity method as solely an entity perspective one-line consolidation was not appropriate given current conceptual thinking and developments in financial reporting. The implications of this would be that any future narrow scope amendments containing proposals analogous to those in ED/2012/3 *Equity Method: Share of Other Net Asset Changes (proposed amendments to IAS 28)* were not appropriate as they reflected a pure entity perspective one-line consolidation approach.

[1] This analysis is this feedback statement is based on the input reported by the nine respondents that responded to EFRAG's SDS paper and does not in any way purport or attempt to be representative of a wider audience.

Analysis of responses

General comments from respondents

Most respondents provided general comments in relation to the equity method and the nature of the EFRAG SDS Paper as well as, or in some cases instead of, responding to the specific questions asked.

Respondents supported the proactive initiative undertaken by EFRAG in stimulating debate about the equity method and contributing to the IASB work in this area. The general comments fell into two main areas:

- how to resolve the issues with the equity method; and
- the usefulness of information provided by the equity method.

How to resolve the issues with the equity method

All respondents agreed that there was a lack of clarity with the principles underlying the equity method or what it was trying to portray and that clarity on the principles was needed before the equity method could be further developed. Some respondents specifically called for a fundamental rethink of its role rather than simply clarifying concepts to assist in the development of amendments to IAS 28.

Many respondents believed that the EFRAG SDS Paper presented a helpful contribution to the discussion on the equity method; although some respondents did not believe that it was possible to deal with the issues surrounding the equity method by adopting an approach as 'binary' as that discussed in the EFRAG SDS Paper. Various respondents indicated that main objective of the IASB should be to clarify what the equity method aims to achieve and what it tries to portray in financial reporting.

Respondents expressed a diversity of views, highlighting that there is no common understanding of the purpose of the equity method. Respondents generally acknowledged that there are various conceptual and application issues in relation to the application of the equity method. However, almost all respondents were clear that viewing the equity method as a pure entity perspective one-line consolidation was not appropriate given current conceptual thinking including recent developments in IFRSs such as the explicit adoption of the entity perspective in IFRS 10 *Consolidated Financial Statements*.

Some respondents highlighted the importance of understanding whether the information provided by the equity method was useful to users considering the nature of the underlying investees it is intended to portray. One respondent included the results of a survey (conducted with users and preparers) in their jurisdiction, which found widespread support for continuing to use the equity method but noted implementation problems similar to those identified in the EFRAG SDS Paper.

Overall, there was limited consensus on whether the ideas explored in the EFRAG SDS Paper could be used to clarify the equity method without a comprehensive reassessment of its underlying role.

Two respondents indicated that the best approach to solving the issues with the equity method did not lie in classifying the equity method as a measurement basis, a one-line consolidation or a hybrid of both. One respondent did not think that clarity on the principles would necessarily assist with addressing the issues identified in the EFRAG SDS Paper.

The other respondent did not believe a binary approach was helpful in this regard, but that the issues stem from both from the definition of the 'group' which makes up the reporting entity and from the lack of a clear objective for the incorporation of the performance of associates and joint ventures in the consolidated financial statements. This respondent also noted that the application of IFRS 11 *Joint Arrangements* has resulted in a significant increase in the number of entities using the equity method.

On that basis the respondent considered that the first step would be to reconsider the definition of ‘the group’ for a reporting entity and completely reassess the basis of exclusive control as determining its boundaries. The respondent believed it would be appropriate to define a group in a broader manner than at present, and based on the group within which value is created. This respondent suggests that the group would include, but account for using different methods, both subsidiaries (under exclusive control) and entities over which the investor enjoys joint control or significant influence and which are an integral part of its activities. These degrees of control or influence expose the investor to risks and rewards which need to be considered.

The respondent concluded that many of the issues perceived with the equity method today could be resolved if the IASB were to develop a new dedicated standard for equity accounting to address the lack of clear objectives for the equity method, the definition of ‘significant influence’ and incomplete guidance on its application.

Focus on usefulness of information of the equity method

One respondent thought that the usefulness of the information provided through the use of the equity method of accounting has a lot to do with the scope of its application. The respondent had recently undertaken a survey in its jurisdiction on the use of the equity method.

The survey identified that almost all stakeholders stated that the equity method of accounting provides useful information for users, as it reflects the financial performance of investees in the group’s financial statements in a timely manner. They also stated that a group’s financial statements will fail to provide useful information to users if they were to measure all equity investments at fair value with changes presented in profit or loss or they were to recognise profit or loss from investments in associates or joint ventures solely on the basis of dividend income. At the same time, preparers identified a number of practical challenges in the application of the equity method of accounting, such as obtaining the information necessary to apply the equity method within a short period of time.

Given the outcome of the survey, the respondent believed that it was not appropriate to make fundamental changes to the existing requirements relating to investments in associates or joint ventures, such as replacing the equity method of accounting with the requirements to measure them at fair value through profit or loss.

Other matters

One respondent noted that there was a general need to improve the terminology of accounting guidance for associates and joint ventures. This respondent also noted that defined terms, especially the implications of the distinction between ‘interests’ and ‘investments’, are not used consistently across IFRSs.

It was noted that the IASB Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* had not included the equity method as one of the potential measurement bases for inclusion in the Conceptual Framework. Given that it was the investor’s investment in the investee that meets the definition of an asset the position of the equity method should be clarified in this respect.

Question 1

> 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 was answered explicitly by five respondents. Three other respondents implicitly replied as part of their general comments.

Three respondents believed the equity method must be a measurement basis, primarily due to the conceptual definition of an asset (the investor does not control the underlying assets of an equity-accounted investee).

The respondents that supported the equity method as a measurement basis also suggested that further work would be needed to determine what type of measurement the equity method was meant to be, including:

- There was limited academic research on whether the equity method is a sensible measurement basis. This respondent concluded that they did not see why the equity method should be preferred to fair value measurement under IFRS 13 *Fair Value Measurement.* Furthermore, they believed that if the equity method is continued, and viewed as a measurement method, it might be that changes in equity-accounted investees should be viewed as akin to holding gains on available-for-sale investments rather than gains on trading investments. Therefore, equity-accounted income and expense should perhaps be recorded as other comprehensive income rather than as part of profit or loss.
- It was not seen how the equity method fits into any of the measurement bases identified in the IASB's Discussion Paper *A Review of the Conceptual Framework for Financial Reporting.* In light of a revised Conceptual Framework, there might be a need for a more substantial rethinking of the accounting for associates and joint ventures.
- Recent IASB amendments to IAS 28 and IAS 39 *Financial Instruments (Recognition and Measurement)* explain that an investment in an associate or a joint venture is a single unit of account, rather than representing the individual assets and liabilities of the investee. In the view of these respondents, both the focus on control in IFRS 10 and the decisions explaining that an investment in an associate and joint venture is a single unit of account are conceptually sound. Hence, the equity method cannot conceptually be a one-line consolidation.

Three respondents viewed the equity method as a hybrid. Reasons given for their views included that while the equity method may have originally been a one-line consolidation it could not be viewed purely as this any longer although it continues to retain elements of consolidation theory and practice. The primary reason for thinking that the equity method could be a hybrid of both measurement and one-line consolidation stems from the fact that IAS 28 is not clearly underpinned by a clear objective of the equity method and what it purports to achieve. These respondents believe that the equity method is a way of accounting that has evolved over time to deal with specific circumstances.

An important consideration noted by one respondent is whether a single accounting method can provide relevant information with respect to entities in which the investor has significant influence and those over which the investor has joint control. For example, whether the treatment of eliminations of unrealised profits on 'upstream' and 'downstream' transactions differ depending on whether an investee is jointly controlled or significantly influenced.

The respondent who viewed the equity method as a one-line consolidation did so principally because this is how it is viewed in local GAAP. The equity method is a widely used method in local GAAP of this respondent; and before an amendment to local law in 2008 to allow the cost method to be applied in the parent only financial statements it was required in the parent only financial statements. This respondent added that, despite the change in local law, not many parent entities have changed to cost.

Question 2

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.

Four respondents explicitly answered this question. The answers given focused on the implications if the IASB were to explicitly decide that the equity method is a one-line consolidation.

Respondents generally agreed with the consequences identified in the EFRAG SDS Paper. They also stated that, if the equity method were to be a one-line consolidation, it should follow the entity concept and procedures in IFRS 10 for the sake of consistency.

However, some respondents stated that it was not clear that an entity perspective equity method would provide relevant information, particularly with respect to other changes in an investee's net assets. As such, if it were to be decided that the equity method was a one-line consolidation, consideration should be given as to whether a proprietary perspective would better achieve this objective and this should be explored further. In addition reconciling the objective sought by the equity method (investor's share of the investee's net assets) with an entity perspective appears to have contributed to the difficulties encountered by the IASB in finding a satisfactory answer to the accounting for changes in the investor's share of the investee's net assets other than the share of comprehensive income or distributions received under IAS 28.

Other comments included:

(a) That the concept of a 'group' as defined in IFRS includes only a parent and its subsidiaries and the term 'one-line consolidation' could be read as bringing as associate within the scope of the group. Given this, the term 'one-line consolidation' should be avoided when referring to the equity method.

(b) If the equity method was considered a one-line consolidation, then the accounting should be aligned with consolidation accounting in all ways, including transaction costs at initial acquisition and additional interests with no change in investment status.

Question 3

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?

Six respondents explicitly answered this question. Those respondents who did not answer directly provided overall input or general comments which are included above.

Responses appeared to implicitly agree with the implications set out in the EFRAG SDS Paper for viewing the equity method as a measurement basis and, in particular, respondents took the view that it would mean there would be no elimination of gains or losses on investor transactions with investees.

One respondent thought it was premature to ask this question and further research was needed.

Another generally believed that a measurement basis more appropriately reflects the underlying economics of transactions concerning investments in an associate or a joint venture. An investment in an associate or a joint venture is a single unit of account. It follows that, in their view:

- transactions between investor and investee should be treated in the same way as transactions with a third party. Therefore, investors' profits or losses arising from such transactions should be recognised in full in the financial statements of the investor; and
- the accounting for investees whose operations are closely integrated with those of the reporting entity needed to be treated differently in order to reflect the underlying economics of the transaction. This could be addressed through the requirements of IFRS 11 *Joint Arrangements* rather than by amending IAS 28.

One respondent thought it was appropriate to include some consolidation techniques in applying the equity method, such as the elimination of profit on upstream and downstream transactions.

One respondent explicitly preferred a one-line consolidation approach where there are significant transactions between investor and investee or where the investor has a significant stake; for instance when the interest held might be close to providing the investor with control.

Another thought the idea has some attractions, but it would be difficult to develop an approach that did not treat all transactions equally (for example distinguishing between where an entity transacts with an associate but the significant influence had no impact on the transaction and where it did have an impact).

Question 4

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?

Four respondents explicitly replied to this question. One noted difficulties with the equity method in general. The other three noted specific areas of problems but it was not clear to what extent these were due to the lack of clarity on the underlying nature of the equity method. Some respondents provided high level solutions on how the issues around the equity method might be addressed, which are explored above in the section General Comments.

These respondents generally share the concerns highlighted in paragraph 40 of the EFRAG SDS Paper which refer to the recent Exposure Drafts on the accounting for share of other net asset changes and sale or contribution of assets between an investor and its associate or joint venture.

The practical issues identified include:

- accounting for transactions between investors and investees in general;
- other net asset changes;
- contingent consideration arrangements;
- impairment testing;
- acquisitions carried out in stages;
- deferred taxes; and
- the challenge in obtaining sufficient information necessary to apply the equity method of accounting.

APPENDIX – List of respondents

Participant	*Country/Region*	*Nature*
Accounting Standards Board of Japan	Japan	National Standard Setter
Accounting Standards Committee of Germany	Germany	National Standard Setter
ACTEO/AFEP/MEDEF	France	Preparer Association
Danish Accounting Standards Committee	Denmark	National Standard Setter
European Accounting Association Financial Reporting Standards Committee	Europe	Academic Association
Federation of European Accountants	Europe	Accounting Association
Moore Stephens	United Kingdom	Accounting/auditing firm
Norwegian Accounting Standards Board	Norway	National Standard Setter
Spanish Institute of Accounting and Auditing	Spain	National Standard Setter