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STAFF PAPER

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Project	**Equity Method in Separate Financial Statements**		
Paper topic	Other decisions		
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Introduction and background

1. In December 2013, the IASB published for comment the Exposure Draft ED/2013/10 *Equity Method in Separate Financial Statements* (proposed amendments to IAS 27 *Separate Financial Statements*).[1] The comment period ended on 3 February 2014.

2. The Exposure Draft proposed that entities have an option to account for investments in a subsidiary, associate or joint venture (together referred to as the 'investees' hereinafter) using the equity method in their separate financial statements.

3. We received 60 comment letters. The staff presented an analysis of the comment letters to the IASB in March 2014. To recap, there was strong support from respondents on the inclusion of the equity method as one of the options to account for an entity's investment in the investees in its separate financial statements. The concerns expressed by some respondents are all matters that were considered by the IASB when the proposals were developed and are not fundamental to the overall proposal.

   (a) Although most respondents agreed with the retrospective application of the proposed amendments, some respondents asked the IASB to consider providing an alternative method to determine the opening

[1] http://www.ifrs.org/Current-Projects/IASB-Projects/IAS-27-Separate-Financial-Statements/Exposure-Draft-December-2013/Documents/Equity-Method-in-Separate-Financial-Statements-December-2013.pdf

balance of the investment in the investees when the proposed amendments are first applied to make it easier to transition to the equity method.

(b) There were mixed responses on the need for a special relief for first-time adopters. Some respondents suggested that some of the paragraphs in IFRS 1 *First-time Adoption of International Financial Reporting Standards* will need to be amended.

(c) There have been mixed responses on the proposed consequential amendments to paragraph 25 of IAS 28 *Investments in Associates and Joint Ventures*. Some respondents think that the IASB needs to revisit the proposed consequential amendments because they think the proposal is inconsistent with the principle in IAS 27 that the investments in the investees are accounted for as equity investments.

(d) There have been other comments on the definition of separate financial statements, accounting for dividends and changes in the ownership interests resulting in changes in the category of the investee.

4. In March 2014, the IASB discussed the feedback from the respondents and tentatively decided to proceed with the proposed amendments to IAS 27, subject to considering the comments on the transition requirements, consequential amendments to paragraph 25 of IAS 28 and the other matters.

5. The purpose of this paper is to:

(a) consider a change in the manner in which the elected method of accounting for an investee is applied;

(b) consider the comments received on the transition requirements;

(c) consider the comments received on the consequential amendments to paragraph 25 of IAS 28; and

(d) consider the comments on some of the other matters;

Staff analysis and recommendations

Application of the elected method of accounting for investees

6. Paragraph 10 of IAS 27 requires an entity to apply the same accounting for each category of investments.

7. As stated in the comment letter analysis presented to the IASB in March 2014, we think that the main principle in IAS 27 that investments in the investees are accounted for as equity investments in an entity's separate financial statements has to be applied consistently. This raises a question on paragraph 10 of IAS 27 which allows an entity to account for each category of its investments, ie subsidiaries, joint ventures and associates, using different methods.

8. Currently and based on the proposed amendments to IAS 27, an entity can account for its investments in subsidiaries at cost; joint ventures using the equity method; and associates in accordance with IFRS 9 *Financial Instruments*. When there is change in the investor's ownership interest in an investee resulting in a change in the category of the investee, for example from a subsidiary to an associate, the entity starts applying a different method to the retained investment in the investee. However, there is no change in the investor-investee relationship and the investment still remains an equity investment. A change in the category of the investment is not a significant economic event that supports a change in the method of accounting in the investor's separate financial statements.

9. Consequently, we think that paragraph 10 of IAS 27 should be amended to require an investor to elect a method of accounting for the investee on an instrument-by-instrument basis. Based on this proposal, the investor will continue to apply the same method of accounting for the investee as long as the investee is a subsidiary, a joint venture, or an associate. This will also reduce the accounting complications arising from changes in the category of investment when different methods are used to account for each category.

Comments on the transition requirements

For entities already applying IFRS

10. The IASB proposed 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*.

11. Although most respondents supported the proposal of requiring retrospective application of the proposed amendments, some of those respondents suggested that the IASB should consider providing some form of transition relief. Other respondents thought that the IASB should allow prospective application, or at least provide additional transition relief.

12. In paragraph BC12 of the Basis for Conclusions on the proposed amendments, we noted that:

    (a) an entity should be able to use the information in its consolidated financial statements for applying the equity method to the subsidiary in its separate financial statements; and

    (b) for investments in associates and joint ventures an entity need not perform an additional procedures and the information available in the consolidated financial statements can be used in the separate financial statements.

13. This is based on the assumption that the entity prepares both consolidated and separate financial statements. However, the following entities may not have the information to apply the equity method retrospectively in the separate financial statements.

    (a) Entities that are exempted in accordance with paragraph 4(a) of IFRS 10 *Consolidated Financial Statements* from preparing consolidated financial statements; and

    (b) Entities that are exempted in accordance with paragraph 17 of IAS 28 from applying the equity method to account for their investments in associates and joint ventures.

14. In respect of investments in subsidiaries, the carrying amount of a subsidiary accounted for using the equity method in the parent's separate financial statements

might not be equal to the net assets of the subsidiary that are attributable to the parent in the parent's consolidated financial statements. The reasons for this difference, including those highlighted by some respondents, include:

(a) Impairment testing requirements in IAS 28 (as noted in paragraph BC10 of the Basis for Conclusions on the Exposure Draft)

(b) Subsidiary that has net liabilities

(c) Reverse acquisitions

(d) Accounting for acquisition-related costs

(e) Capitalisation of borrowing costs on assets of subsidiary

15. An entity, in the circumstances described in paragraphs 13(a), 13(b) and 14 of this paper (hereinafter referred to as the 'affected entity'), electing to change to the equity method may have to incur costs in terms of time and resources to retrospectively apply the equity method to the investments in the investees in its separate financial statements.

16. Some respondents suggested that the IASB should consider allowing the affected entities to use the amounts recognised in the consolidated financial statements of the entity or of its ultimate parent company for the investees as the opening balance when the amendments are first applied, and apply the equity method as described in IAS 28 after that date.

17. The consequences of using the above approach are as follows:

(a) The cost of acquisition of the investees in the consolidated financial statements of the affected entity's ultimate parent or any intermediate parent might not be the same as the cost of acquisition of the investees in the affected entity's financial statements for several reasons. One possible reason is because the affected entity was acquired by its parent in a past business combination and the affected entity's parent would have recognised the investment in the investee at fair value in accordance with IFRS 3 *Business Combinations*. Consequently, deriving the opening balance of an investment in the investee using the approach suggested by the respondents may result in push-down of fair values from the parent to the affected entity.

(b) In respect of the affected entity's investment in a subsidiary, the opening balance derived using the suggested approach might be inconsistent with the equity method procedures as described in IAS 28 for reasons such as:

    (i) net liability position of the subsidiary; or

    (ii) net assets of the subsidiary include borrowing costs of another group entity; or

    (iii) impairment losses, if any, are recognised at the individual asset-level.

18. Although the approach suggested by the respondents has certain consequences and may be inconsistent with the equity method procedures, we think that an entity could be allowed to use the carrying value of the net assets of the investees attributable to the entity in the consolidated financial statements of the entity or of its ultimate or any intermediate parent as the opening balance when the amendments are first applied because the costs incurred by the entity for deriving the opening balances using this alternative approach are expected to be lower than the costs involved, in terms of time and resources, in full retrospective application of the proposed amendments.

For first-time adopters

19. The IASB proposed that first-time adopters not be given any special relief. 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.

Paragraph C5 of IFRS 1

20. Most of the respondents recommended that paragraph C5 of IFRS 1 should be amended to clarify that the exemption for past business combinations also applies to investments in subsidiaries accounted for using the equity method in the separate financial statements of the first-time adopter. Paragraph C5 of IFRS 1 states that "the exemption for past business combinations also applies to past acquisitions of investments in associates and of interests in joint ventures…"

21. We agree with the recommendation, because the amendment would make paragraph C5 more explicit. Alternatively, this can be clarified in paragraphs D14–D15 of IFRS 1 which provide the exemption for investments in subsidiaries, joint ventures and associates in the investor's separate financial statements.

Paragraph D15 of IFRS 1

22. Some respondents suggested that the IASB should consider amending paragraph D15 of IFRS 1 to allow a first-time adopter electing to use the equity method in its separate financial statements, to use the deemed cost for measuring the investments in the investees in its opening statement of financial position. One of the respondents, referring to the Basis for Conclusions on IFRS 1, stated that the rationale for the deemed cost exemption, which is the practical difficulty to apply IAS 27 retrospectively, is applicable when a first-time adopter applies the equity method. Deemed cost of the investment is defined in paragraph D15 as either the fair value at the date of transition to IFRS in the separate financial statements or the previous GAAP carrying amount at that date. We think that paragraph D15 should not be amended because the rationale for allowing the use of deemed cost to measure the investments, especially in joint ventures and associates, in the separate financial statements of the first-time adopter will also apply to the consolidated financial statements. If the deemed cost exemption is extended to the consolidated financial statements, the exemption for past acquisitions of joint ventures and associates in Appendix C of IFRS 1 becomes irrelevant.

Paragraph D17 of IFRS 1

23. Some respondents suggested that paragraph D17 of IFRS 1 should also be amended to extend its applicability to the separate financial statements of an entity if the entity adopts IFRS later than its investees.

24. Paragraphs D16 and D17, which provide the exemption for assets and liabilities of subsidiaries, associates and joint ventures, are essentially meant for consolidated financial statements of the first-time adopter. Paragraph D17, which states that "if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments", does not apply to investments in subsidiaries, joint

ventures and associates in the separate financial statements of the first-time adopter because paragraphs D14 and D15 provide specific exemption on accounting for investments in subsidiaries, joint ventures and associates in the separate financial statements of the first-time adopter.

25. However, we think that the considerations that had been discussed for initial application for entities already applying IFRS, especially for investments in subsidiaries, also apply to first-time adopters. Consequently, we think that a transition relief similar to that discussed in paragraph 18 of this paper should be provided to a first-time adopter. We recommend that the exemption "investments in subsidiaries, joint ventures and associates" be amended so that all the exemptions relating to separate financial statements would be at one place rather than spread across various exemptions.

Comments on the proposed consequential amendments to IAS 28

26. The IASB proposed to amend paragraph 25 of IAS 28 in order to avoid a conflict with the principles of IFRS 10 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.

27. Based on the staff's proposal, if entities are required to elect and apply a method of accounting for the investees on an instrument-by-instrument basis (see paragraphs 6–9 of this paper) instead of the current requirement in paragraph 10 of IAS 27 that same accounting is applied for each category of investees, these proposed consequential amendments to paragraph 25 of IAS 28 will no longer be needed because an entity will continue to apply the same method of accounting for the investment even after a change in the category, for example from subsidiary to associate.

Other matters

Definition of separate financial statements

28. Some respondents commented that the proposed amendments to paragraphs 4 and 6 of IAS 28 create an inconsistency in the definition of separate financial

statements, especially for an investor that has investments in associates or joint ventures and no investments in subsidiaries. The financial statements of such investor in which the investments in joint ventures and associates are accounted for using the equity method would be the investor's primary financial statements as well as its separate financial statements. Consequently, they assert that there could be confusion on the applicability of the disclosure requirements in IAS 27 and IFRS 12 *Disclosure of Interests in Other Entities*. IFRS 12 does not apply to an entity's separate financial statements.

29. We think that the financial statements of an investor that has no investments in subsidiaries and has investments in associates or joint ventures which are accounted for in accordance with IAS 28 are not separate financial statements. Consequently, such investor is required to comply with the disclosure requirements in IFRS 12. As a logical conclusion, we don't expect such investor to prepare separate financial statements using the equity method of accounting for investments in associates or joint ventures. However, if such investor elects to present separate financial statements, we think that the investor is likely to account for its investments in associates or joint ventures either at cost or in accordance with IFRS 9.

30. To eliminate the perceived confusion, we think that:

    (a) the definition of separate financial statements should be simplified by removing references to a parent, or an investor in a joint venture or an associate, and defining separate financial statements as those presented by an entity in which its investments in subsidiaries, joint ventures and associates are accounted for either at cost, or in accordance with IFRS 9, or using the equity method procedures as described in IAS 28; and

    (b) it should be explicitly stated in IAS 27 that the financial statements of an investor that has no investments in subsidiaries and has investments in associates or joint ventures which are accounted for in accordance with IAS 28 are not separate financial statements.

Accounting for dividends

31. Some respondents commented that the proposed amendments to paragraph 12 of IAS 27 on accounting for dividends from the investees are inconsistent with the guidance in IFRS 9. Dividends that clearly represent a recovery of part of the cost of the investment cannot be recognised in profit or loss.

32. Paragraph B5.7.1 of IFRS 9 is reproduced below (emphasis added):

> Paragraph 5.7.5 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. This election is made on an instrument-by-instrument (ie share-by-share) basis. Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity. *Dividends on such investments are recognised in profit or loss in accordance with IAS 18 unless the dividend clearly represents a recovery of part of the cost of the investment.*

33. Paragraph 12 of IAS 27 was proposed to be amended to state that a dividend from a subsidiary, a joint venture or an associate is recognised in profit or loss if the entity elects to measure the investment at cost or in accordance with IFRS 9. IFRS 9 provides guidance on accounting for dividends. Consequently, we think that it is appropriate that dividends are accounted for in accordance with IFRS 9 when the entity elects to measure the investments in accordance with IFRS 9.

Other amendments to IAS 28

34. Some respondents commented that other paragraphs in IAS 28 should be amended to enable entities to apply the equity method to subsidiaries in the separate financial statements. For example, paragraph 2 of IAS 28 states that "this Standard shall be applied by all entities that are investors with joint control of, or significant influence over, an investee". However, the proposed amendments extend the scope to investments in subsidiaries in the separate financial statements. Similarly, paragraph 22 states that an entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate

or joint venture and becomes a subsidiary, in which case the entity shall account for its investment in accordance with IFRS 3 *Business Combinations* and IFRS 10. However, this will not be the case in the separate financial statements.

35. As stated earlier in this paper we think that this is a facilitative amendment, and it is not the intention of the IASB to amend IAS 28 to provide guidance on the application of the equity method to an investment in subsidiaries in the separate financial statements of the parent. Further, the staff's proposal that the election of the method of accounting should be on an instrument-by-instrument basis will negate the need for amending IAS 28. Hence, entities electing to apply the equity method to account for subsidiaries in their separate financial statements should follow the equity method procedures as described in IAS 28.

Questions for the IASB

1. Does the IASB agree to amend paragraph 10 of IAS 27 to require an investor to elect a method of accounting for the investee on an instrument-by-instrument basis?

2. Does the IASB agree with the staff's recommendation to allow the alternative method to compute the carrying value of the investment on initial application of the proposed amendments or on first-time adoption?

3. Does the IASB agree to withdraw the proposed consequential amendments to paragraph 25 of IAS 28?

4. Does the IASB agree with the recommendation to amend the definition of separate financial statements and explicitly state that the financial statements of an investor that has no investments in subsidiaries and has investments in associates or joint ventures which are accounted for in accordance with IAS 28 are not separate financial statements?

5. Does the IASB agree with amending paragraph 12 of IAS 27 to clarify that dividends are accounted for in accordance with IFRS 9 when an entity elects to account for the investments in accordance with IFRS 9?