STAFF PAPER

March 2014

IASB Meeting

Project	Equity Method in Separate Financial Statements		
Paper topic	Analysis of comment letters		
CONTACT(S)	Raghava Tirumala	rtirumala@ifrs.org	+44 (0)20 7246 6953

Introduction

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 proposes 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. These proposals are in response to the requests received during the IASB's 2011 Agenda Consultation.

3. We received 60 comment letters. A summary of the demographic profile of the respondents is provided in the Appendix to this paper.

[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

Overview

4. The main messages were as follows:

   (a) 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.

   (b) 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 balance of the investment in the investees when the proposed amendments are first applied.

   (c) 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 will need to be amended.

   (d) 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.

   (e) 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.

Analysis of the comment letters

5. This paper provides the summary of the comments on:

   (a) Q1—Use of the equity method in separate financial statements (paragraphs 6 to 16)

   (b) Q2—Transition provisions (paragraphs 17 to 23)

   (c) Q3—First-time adopters (paragraphs 24 to 32)

(d) Q4—Consequential amendment to IAS 28 (paragraphs 33 to 40)

(e) Q5—Other comments (paragraphs 41 to 52)

Comments on Q1, Use of the equity method

Background

6. The IASB proposed to permit the equity method as one of the options to account for an entity's investments in subsidiaries, joint ventures and associates in the entity's separate financial statements.

Summary of comments

7. Most respondents agreed with the proposal to permit use of the equity method as one of the options to account for an entity's investments in the investees in the entity's separate financial statements.

8. A few respondents suggested that the IASB should consider requiring, instead of giving an option to, entities to use the equity method in the separate financial statements to account for investments in the investees.

9. In expressing their support for the proposals, some respondents expressly stated that application of the equity method to investments in the investees in the separate financial statements of an entity will result in the same net assets and profit or loss attributable to the owners as in the entity's consolidated financial statements. Others asked the IASB to consider providing additional guidance to align the carrying amount of a subsidiary in the parent's separate financial statements with the net assets of the subsidiary that are attributable to the parent in the parent's consolidated financial statements. For these respondents, it seems that they view the equity method as a one line consolidation and that this characterisation is important to them.

10. Some respondents, having agreed with the proposals as a short-term measure for removing a difference between IFRS and the local requirements in some jurisdictions, strongly recommended the need for a fundamental assessment of the equity method and the purpose of separate financial statements.

11. The respondents who disagreed with the proposal did so on, one or more of, the following grounds:

    (a) The proposed amendments would result in the IASB inappropriately setting a precedent of amending IFRS to address local legislative requirements or the locally accepted accounting principles in particular jurisdictions.

    (b) IAS 27 does not clearly explain the purpose of separate financial statements and only describes them as the financial statements in which investments in the investees are accounted for at cost or in accordance with IFRS 9 *Financial Instruments*. Use of the equity method may not be consistent with paragraph BC10 of the Basis for Conclusions on IAS 27, which states that for separate financial statements, the focus is upon the performance of the assets as investments.

    (c) There is no clarity on whether the equity method is conceptually a 'one-line consolidation' or a 'measurement method. Any amendments to IFRS in relation to the application of the application of the equity method should be considered as part of the research project, and the Exposure Draft should be set aside till the completion of the research project.

    (d) The proposal to provide an additional option is inconsistent with the IASB's aim to reduce the number of accounting options in IFRS. Complexities would arise when an entity accounts for each category of its investments in the investees using a different method and there is a change in the category of an investment because of changes in the entity's ownership interest in the investee.

Staff analysis

12. We think that this is a facilitative amendment. Any effort to establish the purpose or basis for preparation of separate financial statements can only be undertaken as part of a comprehensive project but not in a narrow-scope project.

13. The relevant portion of paragraphs BC7 and BC10 of the Basis for Conclusions on IAS 27 are reproduced below (emphasis added):

> BC7 … **The Board draws a distinction between accounting for such investments as equity investments and accounting for the economic entity that the parent controls**. In relation to the former, the Board decided that each category of investment should be accounted for consistently.
>
> BC10 … **For separate financial statements, the focus is upon the performance of the assets as investments**. The Board concluded that …

14. Essentially, in the separate financial statements of an investor, investments in the investees are accounted for as equity investments. We think that this principle should be consistently applied, and these proposals to allow the equity method should not be viewed as an attempt to make separate financial statements a proxy of the consolidated financial statements of the investor.

15. Regarding the requests from some respondents to fully align the equity method as applied to a subsidiary to the consolidation procedures, we think that this is not possible for the following reasons:

    (a) This is outside the scope of the project.

    (b) Currently, the equity method as described in IAS 28 is a mixed model with characteristics of both one-line consolidation and a measurement method. IAS 28 has to be amended to respond to the requests, which is not possible without a fundamental assessment of the equity method.

    (c) Any effort to align the accounting by amending IAS 28 would create an inconsistency with some of the principles in IAS 1 *Presentation of Financial Statements* and IFRS 10 *Consolidated Financial Statements*.

    (d) One possible approach is to define a new method, say, 'one-line consolidation method' to account for an investment in subsidiary in the separate financial statements of a parent in such a manner that the carrying value of the investment in subsidiary in the separate financial statements is same as the net assets of the subsidiary that are attributable to the parent in the parent's consolidated financial statements. This may not be consistent with the principle in IAS 27, and cannot be achieved without a fundamental assessment of the purpose or basis for the preparation of separate financial statements.

16. In summary, there is general support for the proposals. The concerns expressed by some respondents are all matters that were considered by the IASB when the proposals were developed. Although we understand the concerns expressed by some respondents we think the benefits are likely to be immediate. Some of the concerns expressed will remain even if we did not finalise the proposals.

Comments on Q2, Transition provisions

Background

17. 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*.

Summary of comments

18. A majority of respondents supported the proposal of requiring retrospective application of the proposed amendments.

19. Some respondents, having agreed that 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, highlighted that:

(a) this assumes that the entity prepares both consolidated and separate financial statements. Entities that avail the exemption in paragraph 4 of IFRS 10 or the exemption from applying the equity method in IAS 28 may not have the information to apply the equity method retrospectively in the separate financial statements. For such entities, some form of transition relief may be appropriate; and

(b) there are more differences between consolidation procedures and the equity method than recognition of impairment losses as discussed in paragraph BC10 of the Basis for Conclusions on the Exposure Draft. For these reasons, entities may have to incur costs in terms of time and resources to retrospectively apply the equity method to an investment in subsidiary in the separate financial statements without much benefit.

20. In the above circumstances, respondents suggested that the IASB should consider allowing the entities, electing to use the equity method in the separate financial statements, 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. These transition requirements would be similar to the transition relief provided in IFRS 11 *Joint Arrangements*.

21. Respondents who disagreed with the proposal gave reasons similar to those discussed in paragraph 19 of this paper, and recommended an approach similar to that discussed in paragraph 20 of this paper.

Staff analysis

22. We think that an entity electing to change to the equity method in its separate financial statements should be required to apply the change retrospectively.

23. However, we agree with the comments and recommendations of the respondents that an entity should be permitted to use the amounts recognised in its consolidated financial statements or of its ultimate parent company for the investees as the opening balance in its separate financial statements when the amendments are first applied.

Comments on Q3, First-time adopters

Background

24. The IASB proposed that first-time adopters do not need 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 *First-time Adoption of International Financial Reporting Standards*.

Summary of comments

25. A majority of respondents who commented on this issue either agreed or supported the proposal that no special relief is required for a first-time adopter.

26. They believe that Appendix C to IFRS 1 provides the exemptions for the application of the equity method by a first-time adopter. One 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.

27. About a third of respondents disagreed with the proposal and recommended that the IASB should provide special relief for a first-time adopter.

28. Most of these 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.

29. 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.

30. 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.

Staff analysis

31. We agree with the recommendation of the respondents to amend paragraph C5[2] of IFRS 1 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.

[2] 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…"

32. Regarding paragraphs D15 and D17 of IFRS 1, we will analyse these comments in detail and bring our recommendations to the next IASB meeting.

Comments on Q4, Consequential amendment to IAS 28

Background

33. 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.

Summary of comments

34. The views were split on this issue. About half of those who commented on this matter supported the proposed consequential amendment to IAS 28.

35. Some of these respondents agreed with the proposed amendment because the application of the principles in IFRS 10 will result in a consistent accounting in both consolidated and separate financial statements when an entity loses control of a subsidiary but retains an ownership interest in the former subsidiary. Other respondents suggested that paragraph 25 of IAS 28 should be clearly articulated to achieve the accounting as explained in paragraph BC11 of the Basis for Conclusions on the Exposure Draft.

36. About half of the respondents who commented on this matter disagreed with the proposed consequential amendment to IAS 28 for the following reasons:

    (a) They believe that there is a disconnection between the consequential amendment to paragraph 25 of IAS 28 and paragraph BC11 of the Basis for Conclusions on the Exposure Draft. The amended paragraph 25 of IAS 28 does not achieve the accounting as explained in paragraph BC11.

    (b) If the proposed consequential amendment is for achieving consistency between the consolidated and separate financial statements of an entity, there are other differences between the consolidation procedures and the equity method that should also be addressed.

(c) IFRS 10 does not apply to a parent's or investor's separate financial statements. Assuming that the principles of IFRS 10 are applied in separate financial statements, the application of those principles is not restricted to the equity method but also when the investments in subsidiaries are carried at cost.

(d) IFRS 10 requires remeasurement of a retained interest in a former subsidiary to fair value because loss of control of a subsidiary is a significant economic event. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship (paragraph BCZ182 of IFRS 10). In an entity's separate financial statements, because investments in the investees are accounted for as equity investments (ie, assets in an investor-investee relationship), any change in the investor's ownership interest resulting in a change in the category of the investment is not a significant change to the existing investor-investee relationship. Consequently, the principles of IFRS 10 should not be applied.

37. Some respondents stated that the amended paragraph 25 of IAS 28 provides accounting guidance on changes in the parent's ownership interest in a subsidiary without loss of control, and does not provide any guidance on situations in which the parent loses control.

38. Some respondents suggested that paragraph 25 should be further amended to clearly state that any retained investment in a former subsidiary is remeasured to fair value, if the IASB's intention is that the principles of IFRS 10 take precedence over IAS 28.

Staff analysis

39. As stated earlier in this paper, 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.

40. We understand the comments from the respondents who disagreed with the proposed consequential amendments. We will analyse these comments in detail and bring our recommendations to the next IASB meeting.

Comments on Q5, Other comments

41. The IASB asked for any other comments on the proposal. Respondents commented on the following matters:

    (a) Definition of separate financial statements

    (b) Accounting for dividends

    (c) Changes in the entity's ownership interests in the investee resulting in a change in the category of the investee

    (d) Differences between accounting for a subsidiary in the consolidated financial statements and using the equity method in the separate financial statements

    (e) Other amendments to IAS 28

Definition of separate financial statements

42. 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.

43. We will analyse these comments in detail and bring our recommendations to the next IASB meeting.

Accounting for dividends

44. 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.

45. 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**.

Changes in the entity's ownership interests in the investee resulting in a change in the category of the investee

46. Some respondents requested the IASB to consider providing guidance on accounting for change in the category of the investee as a consequence of changes in the entity's ownership interest in the investee when the entity uses different method to account for each of the categories of the investees. Some other respondents think that the proposed amendments are facilitative and any effort to provide guidance would complicate the proposed amendments.

47. Some respondents requested the IASB to revisit the need to apply a different method to each of the categories of the investees. The election of the method of accounting should be made on an instrument-by-instrument basis instead of the category of the investee.

48. As stated earlier in this paper we think that this is a facilitative amendment, and the proposals should not be complicated by including guidance on accounting for changes in the category of the investee.

Differences between accounting for a subsidiary in the consolidated financial statements and using the equity method in the separate financial statements

49. Some respondents commented that the net assets and profit or loss of the subsidiary attributable to the investor would not be the same in its consolidated financial statements and its separate financial statements prepared using the equity method for reasons other than recognition of impairment losses, which are as follows:

    (a) Subsidiary that has net liabilities

    (b) Reverse acquisitions

    (c) Accounting for acquisition-related costs

    (d) Capitalisation of borrowing costs on assets of subsidiary

50. These respondents suggested that the IASB should consider referring to these other reasons in the basis for conclusions in the final amendment.

Other amendments to IAS 28

51. 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.

52. 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. 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.

Staff's conclusion and recommendation

53. We think that there is general support for the inclusion of the equity method as one of the options to account for the investees in the separate financial statements of an entity. The concerns expressed by some respondents are all matters that were considered by the IASB when the proposals were developed. We recommend that the IASB should proceed with the proposed amendments.

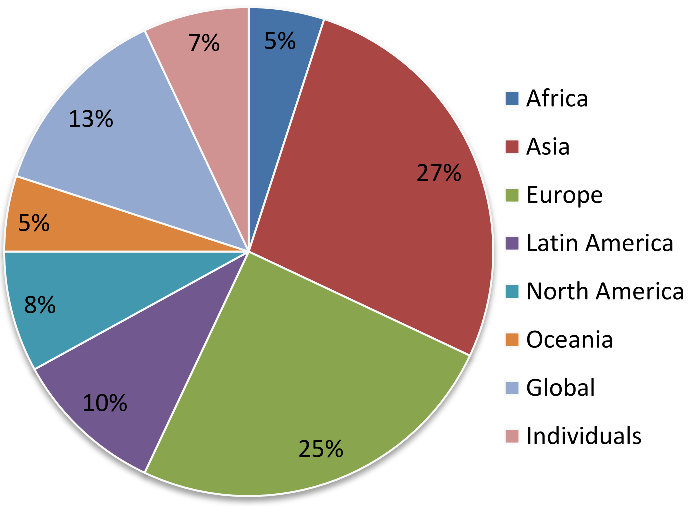
54. We will bring more analysis on the transition requirements, consequential amendments to paragraph 25 of IAS 28 and some of the other matters to the next IASB meeting with the aim of finalising the proposed amendments.

Questions for the IASB
Does the IASB agree with the staff's recommendations to proceed with the proposed amendments?

Appendix—Demographic profile of the respondents

Distribution by geographic region

Region	Respondents	
	Number	%
Africa	3	5%
Asia	16	27%
Europe	15	25%
Latin America	6	10%
North America	5	8%
Oceania	3	5%
Global	8	13%
Individuals	4	7%
TOTAL	**60**	**100%**



Distribution by type of entity

Region	Respondents	
	Number	%
Academia or Think tank	1	1%
Accountancy body	10	17%
Accounting firms	9	15%
Individuals	4	7%
Preparers	9	15%
Preparer representative bodies	3	5%
Securities regulators	3	5%
Standard-setting bodies	21	35%
TOTAL	**60**	**100%**