STAFF PAPER

6 November 2014

Prepared for the Global Preparers Forum Meeting

Project	**The Equity Method of Accounting**		
Paper topic	Application of the Equity Method of Accounting		
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Introduction

1. The International Accounting Standards Board (IASB) has added to its research agenda a project on the equity method of accounting. The project was added in response to feedback received to the IASB's 2011 Agenda Consultation.

2. The IASB discussed the scope of the project at its meeting in May 2014 (Agenda Paper 13). At that meeting the IASB decided to review the circumstances in which the equity method is applied in current IFRS, with the objective of identifying the financial reporting problem (or problems) in the application of the equity method. The IASB emphasised that it intends to focus on identifying problems related to the equity method, to ensure that it does not attempt to resolve problems that are not clearly identified.

Feedback sought

3. We are seeking feedback on the practical difficulties in the application of the equity method of accounting as set out in IAS 28 *Investments in Associates and Joint Ventures*.

Background

2011–2012 Agenda Consultation

4. The application of the equity method of accounting was raised by respondents to the 2011 Agenda Consultation as a topic to be considered. Consequently, as noted above, the IASB added the Equity Method of Accounting project to its research agenda in response to feedback received to the 2011 Agenda Consultation. A

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review of the Agenda Consultation responses, which address the equity method of accounting, include two themes: (a) researching the conceptual merits of the equity method; and (b) a need to simplify the equity method. These two themes are, however, related because some of the respondents who suggested reviewing the conceptual merits of the equity method considered that providing a conceptual underpinning to the equity method could lead to a simplification of its requirements.

5. In agreeing the scope of the Equity Method project the IASB decided to:

   (a) review the circumstances in which the equity method of accounting is required in current IFRS to identify and evaluate the financial reporting problem (or problems) that application of the equity method seeks to resolve; and

   (b) review problems related to the application of the equity method of accounting as required by IAS 28.

6. In reviewing the circumstances in which the equity method is applied, it is envisaged that we will gain a better understanding of why this method is used and might be preferred over other accounting.

7. The review will help make sure that we address existing problems in practise.

Defining the financial reporting problem the equity method seeks to resolve

8. Over the last 10 years the IASB has given more importance to the concept of control. This is why proportionate consolidation is no longer used and also why there are conflicting requirements between older Standards that require ‘unrealised’ gains on transactions with associates or joint ventures to be eliminated and more recent Standards that require such gains to be recognised.

9. As part of our review of the circumstances in which the equity method of accounting is applied, in Appendix A of this paper we have summarised the accounting for investments. When a non-controlling interest is held, the accounting requirements range from the equity method to fair value through profit or loss or through other comprehensive income.

10. Current Standards require the application of the equity method for joint ventures and in circumstances in which an investor has significant influence over the

investee. However, fair value is used in some circumstances depending on the characteristics of the investee (such as whether it is an investment fund).

11. The equity method of accounting was developed as a response to the concern noted in paragraph 11 of IAS 28:

> The recognition of income on the basis of distributions received may not be an adequate measure of the income earned by an investor on an investment in as associate or a joint venture because the distributions received may bear little relation to the performance of the associate or joint venture.

Question 1 – Defining the problem

Do GPF members consider that applying the equity method is better than simply accounting for investments:

(a) at cost and recognising distributions from the investee; or

(b) at fair value?

If so why?

Addressing the application issues of the equity method

12. As noted previously, some respondents to the 2011 Agenda Consultation consider that the equity method should be simplified. To consider simplifications to the equity method we first need to identify the common application issues with the equity method as set out in IAS 28. The concern about application issues is supported by the number of amendments and queries that have been addressed recently by the IFRS Interpretations Committee and the IASB in relation to IAS 28. Appendix B summaries the recent amendments/queries that relate to IAS 28.

13. Based on the list in Appendix B and reviews of current literature we have identified the following list of application issues:

Information needs

(a) availability of information in a timely manner;

(b) adjustments necessary to the associate or joint venture entity's financial statements to conform accounting policies;

Procedures similar to consolidation procedures

(c) determination of fair value adjustments and goodwill arising from the acquisition of the investment in the associate;

(d) contingent consideration;

(e) acquisitions carried out in stages;

(f) changes in ownership in which significant influence is retained;

(g) gains and losses from 'upstream' and 'downstream' transactions that are recognised to the extent of unrelated investors' interests in the associate or joint venture;

(h) treatment/elimination of transactions between associates and subsidiaries; and

Other areas

(i) impairment testing.

Question 2—Application of the equity method

Do GPF members:

(a) agree with the items included in the above list?

(b) know of other application difficulties associated with the equity method that have been omitted from the above list?

Related party disclosures

14. As noted previously, respondents have raised the elimination entries required by IAS 28 as an application issue. At present, IAS 28 outlines that many of the procedures that are appropriate for the application of the equity method are similar to consolidated procedures.

15. Elimination entries in the preparation of consolidated financial statements ensure that the consolidated financial statements show the result of the parent entity and the entities that it controls as a single economic entity. The same cannot be said when the equity method of accounting is applied as associate and joint venture entities that are not controlled by the parent and are therefore outside the single economic entity.

16. Elimination entries when the equity method is applied may relate to the understanding of transactions between related parties. It was identified in paragraph 11 that the equity method is applied because the distribution received may bear little relation to the performance of the associate or the joint venture. A disconnection between distributions and results could arise if an investor uses its significant influence or joint control to influence the payment of dividends. Similarly, some of the application issues that the IASB has sought to address through its narrow-scope amendments to IAS 28 appear to be related to understanding the impact on the results of groups of transactions with associate and joint venture entities.

17. In considering simplifications of the equity method, we believe that it will be important to consider whether a simplified equity method could be supported by amending the disclosures with regard to the related party transactions. That is, whether disclosures addressing how transactions between an associate, a joint venture and the parent entity affect the results of the consolidated financial statements and thus could enable simplification of the equity method as currently applied in IAS 28.

Question 3- Related parties disclosures
Do GPF members believe that it will be important to consider whether a simplified equity method could be supported by amending the disclosures with regard to the related party transactions?

Appendix A—Accounting for Investments

Nature of investment	Description of investment	Accounting
Simple investment	Ownership rights. No ability to influence. Investor can sell or hold.	Fair value depending on circumstance through other comprehensive income or profit and loss. Circumstances for other comprehensive income—not held for trading.[1] These investments are held for non-contractual benefits rather than primarily for increases in the value of the investment.
Associate	Ownership rights. Investor can influence activities to change future cash flows. Investor can sell or hold.	Equity method.
Joint control	Ownership rights. Joint control, consent required on relevant activities to change future cash flows. Investor can sell or hold.	Equity method.
Subsidiary	Ownership rights. Controls activities. Investor can sell or hold.	Consolidation.
Investment entities	Ownership of rights, ability to control but the investment entities: (a) obtain funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) have commitments to its investor(s) that its business purpose is to invest funds solely for return from capital appreciation, investment income or both; and (c) measures and evaluates the performance on a fair value basis.	Fair value through profit and loss.

[1] See paragraph BC5.22 of IFRS 9.

Appendix B—Recent activities related to the equity method of accounting

Issue	
Acquisition of an Interest in a Joint Operation	The IASB issued an amendment in May 2014 to IFRS 11 *Joint Arrangements* that requires the acquirer of an interest in a joint operation in which the activity constitutes a business, as defined in IFRS 3 *Business Combinations,* to apply all of the principles on business combinations accounting in IFRS 3 except for those principles that conflict with the guidance in IFRS 11.
IFRS 10 and IAS 28 (2011): Sale or Contribution of Assets between an Investor and its Associate or Joint Venture	The IASB issued an amendment in September 2014 to IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*. The main consequence of the amendments is that a full gain or loss is recognised when a transaction involves a business (whether it is housed in a subsidiary or not). A 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.
Separate financial statements: use of the equity method	The IASB issued an amendment in August 2014 to IAS 27 that permits entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements.
Application of the equity method by a non-investment entity investor to an investment entity investee	The IASB has published an Exposure Draft that aims to clarify: (a) the accounting by an investment entity that has a subsidiary that meets the definition of an investment entity and, additionally, that provides investment-related services; (b) whether the exemption to present consolidated financial statements, as set out in paragraph 4 of IFRS 10, is available to entities affected by the Investment Entities amendments;[2] and (c) the application of the equity method by a non-investment entity investor to an investment entity investee.
Elimination of gains or losses arising from transactions between an entity and its associate or joint venture	The objective of this project is for the IASB to clarify the accounting for a 'downstream' transaction between an entity and its associate or joint venture, when the gain from the transaction exceeds the carrying amount of the entity's interest in the associate or joint venture.

[2] *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27) was issued in October 2012.

Issue	
Associates and common control	The IFRS Interpretations Committee considered whether it is appropriate to apply the scope exemption for business combinations under common control, by analogy to the acquisition of an interest in an associate or a joint venture under common control.
Fund manager's significant influence over a fund	The IFRS Interpretations Committee has received a request to clarify what factors may indicate that a fund manager has significant influence over a fund that it manages and has a direct holding in.