IASB's Equity Method of Accounting Project
Proposed Scope of Research Project

Introduction

1 This paper is intended to help scope the IASB's project on the equity method of accounting as it is applied in consolidated financial statements.

2 EFRAG and others have argued and also brought evidence[1] that the equity method is considered useful by users of financial statements and should be retained, i.e. no evidence has been brought to support a complete overhaul of the equity method requirements is needed.

3 In line with its statement of "not revising what is not broken", the IASB should not embark on a long-term project aiming at the elimination of the equity method. Rather, it ought to work with the specific purpose of providing a basis for, and resolving the difficulties that are encountered in, the application of the equity method.

4 Good starting points are EFRAG's previous work in its Short Discussion Series: *The equity method: measurement basis or one-line consolidation?* issued in January 2014 and thoroughly supplemented by the work of the Korean Accounting Standards Board (KASB) in their Research Report No. 35 *The Equity Method* issued in September 2014.

5 A comprehensive outreach to users should support the development of the project, so that the decisions made in the project ensure that the equity method provides users with valuable information. This outreach to users should be led jointly between the IASB and ASAF members.

Scope of the IASB's Equity Method of Accounting Project

6 To fulfil the objectives outlined above, the IASB should cover the following aspects.

A. Select an approach that brings the necessary backbone principle to the purpose and use of the equity method

7 The KASB Research Report has well illustrated the inconsistencies encountered in the current IFRS literature and proposed three different approaches to rationalise how the equity method could apply. The IASB should consider those approaches, compare their relative merits given what is intended to be portrayed and the information content brought by the equity method, select one (adjusted if necessary) and draw conclusions following a similar logic as that used by the KASB.

B. Rationalise a scope for the use of the equity method in the consolidated financial statements

8 Many have highlighted the shortcomings in the current definition of significant influence, and questioned whether such a criterion appropriately differentiates different economic relationships between a reporting entity[2] and its equity-accounted investees.

[1] For example see the ASBJ paper *Feedback to the Survey on Equity Method of Accounting* issued in December 2014.

[2] This paper uses the term "reporting entity" to mean a consolidated group in accordance with IFRS 10.

9 The KASB Research Report noted that the boundaries of economic activity of a reporting entity are not limited to the 'group' as determined by the definition of control under IFRS 10 *Consolidated Financial Statements*.

10 EFRAG does not question the use of the group in IFRS. However, it considers that the economic activities of a reporting entity may extend beyond the group through strong inter-relationships with other entities.

11 In order to improve the scope of the equity method, the IASB should consider introducing the notion of strong inter-relationships between the economic activities of the reporting entity and those entities where the reporting entity holds an equity interest that is insufficient to lead to control. Although we focus initially on associates, we note that this would equally apply to both joint ventures under IFRS 11 *Joint Arrangements* and associates under IAS 28 *Investments in Associates and Joint Ventures*, and not depend solely on the nature of the interest held.

What is the thinking behind "strong inter-relationship"?

This paper tentatively proposes that the IASB consider that a strong inter-relationship arises when an equity interest held by the reporting entity but outside the group contributes to the activities of the reporting entity. For example, the equity interest may contribute to the development of goods or services by providing raw materials or other inputs to the reporting entity (upstream transactions) or by assisting in delivering the goods or services of the reporting entity to customers (downstream transactions).

Indicators of a strong inter-relationship between the equity interest and the reporting entity may be, in isolation or in combination, the following:

(a) the reporting entity has significant input into the economic activities of the equity interest;

(b) transactions between the equity interest and the reporting entity are material;

(c) there is technological, customer/supplier or other inter-dependencies between the reporting entity and the equity interest;

(d) that strong inter-relationship is sustainable (requiring an adequate holding of an equity interest); and

(e) the economic activities of the reporting entity are enhanced by the activities of the equity interest. That is, the exposure to returns arises not only from ownership benefits (dividends and changes in the price of the equity interest) but also from factors such as synergies between the activities of the reporting entity and the equity interest.

12 The notion of strong inter-relationship would apply in addition to the ability to exercise influence on the decisions made in the investee. A supplementary notion that would have to be discussed is whether having the ability – in contrast with exercising the ability – would be sufficient to require the use of the equity method.

13 If it is accepted that it is useful to provide information about the extent of economic activity undertaken by a reporting entity, it follows that a method for recognising the economic activities undertaken by equity interests outside the reporting entity but with a strong inter-relationship to the reporting entity is required. In view of the very existence of the strong inter-relationship to the reporting entity, such equity interests cannot be regarded as simple financial assets. Such a method should be as consistent as possible with how the financial performance of the consolidated businesses is reported. It can be argued that the equity method does just that.

C. Assess and decide how equity interests which do not meet the criteria for being accounted for under the equity method should be accounted for

14 Rationalising the scope of equity interests that qualify for being accounted for under the equity method would lead to questioning how any investments that are scoped out as a result of the rationalised scope should be accounted for.

D. Decide whether the application of the equity method should aim at reflecting a share of net assets of the investee or rationalise why it should not necessarily be the case

15 In the view of many, the equity method is described as a method that measures the investment in an investee reflecting the share in the net assets that is being held through the equity interest. In its project, the IASB should consider why this is not the current outcome and consider whether departures from such an outcome are necessary to provide relevant information to users of financial statements.

E. Revisit all existing standards to determine whether a change is needed to be consistent with the principled basis selected

15 Since 2002 when improvements to IFRS were decided, and later when new standards such as IFRS 3 *Business Combinations* and IFRS 10 were issued, IFRS have been developed on the basis of revised concepts: affirmation of exclusive control for consolidation, entity concept, gain or loss of control being perceived as significant economic events etc. All this has led to creating inconsistencies between standards such as IFRS 10 and IAS 28 or leaving requirements without an underlying rationale.

16 Following the approach developed by the KASB should help eliminate those inconsistencies. The project should however include the scrutiny of all requirements in IAS 28, IFRS 3, IFRS 10 and IFRS 11 to ensure that most if not all inconsistencies are removed and a proper rationale supports all revised or retained requirements. This may inevitably lead to revisiting some of the conclusions reached in recent narrow-scope amendments and help solve the issues which have been left pending. Bringing rationale for making different decisions depending on whether a group of assets that constitutes a business should be included in the list of issues that need to be addressed.

Project status and way forward

17 Given the research undertaken so far by the KASB and others, all this in response to the divergent practices that were developing and the limitations encountered in proceeding by way of narrow-scope amendments, this project should qualify for the "Research Development" category. EFRAG, the KASB and others who have to date developed activities or commented on EFRAG or KASB papers (such as the ASBJ) to help frame the necessary standard setting effort could be asked to contribute to this project.

18 It is too early to decide whether the output of this development phase should be an exposure draft or a discussion paper. The decision should be made, depending on whether selecting among possible approaches raises controversy in future ASAF discussions, and after having received advice from the IFRS Advisory Council.