STAFF PAPER

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Accounting Standards Advisory Forum Meeting

Project	The Equity Method of Accounting		
Paper topic	Approach to the project		
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Objective

1. At this meeting we are seeking the advice of the Accounting Standards Advisory Forum (ASAF) on the approach to the Equity Method of Accounting research project.

Advice sought

2. We have been considering the feedback we have already received on this project, and in view of what we have heard so far, we are now seeking advice from ASAF members on:

   (a) whether the Equity Method of Accounting research project should be separated into:

      (i) A short-term project that has the objective of addressing application issues by simplifying the current requirements in IAS 28 *Investment in Associates and Joint Ventures*.

      (ii) Following completion of the short-term project, a longer-term project that has the objective of reconsidering more fundamentally the financial reporting of investments in entities that do not give the investor control of the entity (including interests in joint ventures and associate entities).

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(b) whether the Equity Method of Accounting research project should consider separately the equity method of accounting in separate financial statements for subsidiary entities.

Background

3. At its meeting in May 2014 the IASB considered a paper (Agenda Paper 13) that discussed the scope for the Equity Method of Accounting research project. 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.

4. At the ASAF meeting in June 2014, the IASB sought the views of ASAF members on the IASB's decision. Overall, ASAF members supported the scope of the project as proposed by the IASB and recommended a high level of stakeholder engagement. However, some ASAF members suggested that it might be useful to consider the project in two stages:

   (a) a short-term simplification project; and

   (b) a long-term conceptual review of the application of the equity method.

5. It was agreed that this approach would require careful balance, because the IASB would need to be confident that any short-term changes would need to be consistent with the longer-term direction of the project.

6. In November 2014 IASB staff discussed the project with its Global Preparers Forum (GPF) advisory group. We received the following feedback from GPF members:

   (a) Applying the equity method of accounting as a one-line consolidation method can be difficult, because it requires information from the

associate or joint venture to determine elimination entries that can be difficult to obtain when the investor does not control the investee.

(b) Where there is joint control or significant influence, the ability to generate profits that are not arm's-length is limited, because prices have to be agreed with the joint venture partner or other investors in the associate entity, which questions the relevance of the elimination entries.

(c) There is a concern as to whether the equity method of accounting is appropriate for all associated entities, as defined by IAS 28. Some GPF members noted a concern that that although an entity holds more than 20 per cent of the voting power in the investee, the entity cannot always access the information required to apply the equity method of accounting.

(d) There is a preference for the use of the equity method of accounting in comparison to cost or fair value.

7. In December 2014 the ASAF considered a research report by the Korea Accounting Standards Board (KASB) and the results of a survey that the Accounting Standards Board of Japan (ASBJ) undertook, both of which addressed the equity method of accounting.[1] These papers initiated a wide-ranging discussion.

8. Following these meetings we have spent some time reflecting on the feedback received and considering how we might proceed with the research project.

Application of the equity method of accounting for joint venture and associate entities

9. IFRS currently requires the application of the equity method of accounting for investments in associate and joint venture entities. Application of the equity method of accounting is also permitted in separate financial statements for investments in subsidiaries.

[1] The full research report can be accessed on the KASB website (KASB research report). A summary of the research report is set out at Appendix A.

10. When the IASB considered the scope of the Equity Method of Accounting research project, it briefly reviewed the history and analysed the reasons for the use of the equity method. This analysis highlights that the objective of the equity method of accounting in current IFRS, when applied to investments in joint ventures and associate entities, is not clear.

11. The lack of clarity as to the objective of the equity method of accounting was discussed by the European Financial Reporting Group (EFRAG) in its short Discussion Paper published in January 2014 *The Equity Method: A Measurement Basis or One-line Consolidation?*[2] This Discussion Paper noted that because joint venture and associate entities are not controlled by an investor, they are not, in accordance with IFRS, part of the group. As a consequence, the equity method cannot conceptually be a one-line consolidation method.

12. This point was also reiterated by some ASAF members at its meeting in December 2014. These members noted that if the definition of assets and liabilities relies on the notion of control, it follows that joint ventures and associates cannot be part of the group, because the entities are not controlled by the investor.

13. The definition of a group within current IFRS is set out in IFRS 10 *Consolidated Financial Statements*. IFRS 10 contains the following relevant definitions:

    (a) Consolidated financial statements—the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

    (b) Group—a parent and its subsidiaries.

    (c) Parent—an entity that controls one or more entities.

    (d) Subsidiaries—an entity that is controlled by another entity.

14. When it developed IFRS 10 *Consolidated Financial Statements*, and amended IAS 28 *Investments in Associates and Joint Ventures* the IASB noted that 'In the

[2] The Discussion Paper can be accessed here: http://www.efrag.org/Front/p300-2-272/EFRAG-Short-Discussion-Series---The-Equity-Method--A-measurement-basis-or-one-line-consolidation-.aspx

case of loss of control … the composition of the group changes. If joint control or significant influence is lost the composition of the group is unaffected.'[3]

15. In its research report the KASB sought to address the conflict by proposing a new dimension—*scope of equity-accounted group*, which set out alternative equity methods of accounting that are more internally consistent. The KASB evaluated the equity method of accounting by considering whether:

    (a) the equity-accounted investment is part of the group;

    (b) the equity-accounted group includes the investor's share of the equity-accounted investment; or

    (c) the scope of the equity-accounted group is confined to only an investor and its subsidiaries—equity-accounted investments are not part of the group.

16. The suppositions that the equity-accounted investment is part of the group, or that the equity-accounted group includes the investor's share of the equity-accounted investment (that is, options (a) and (b) in paragraph 15) as set out in the KASB's proposals) are not consistent with current IFRS. Applying these suppositions would require a change to the definitions included in IFRS 10.

17. However, if we were to presuppose that the group is confined to the parent and its subsidiaries (which would be consistent with IFRS 10), one approach to the Equity Method of Accounting research project would be to divide the project into two:

    (a) a short-term project that assesses whether that presumption helps solve current problems with applying the equity method, perhaps by amending IASB 28 and changing how it is characterised and applied.

    (b) A longer-term project could involve a more of a fundamental rethink of whether the equity method is the best way to account for non-controlling interests (including investments in associates and joint venture entities).

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[3] Paragraph BC28 of IAS 28.

18. We note that the presumption that control is the basis for determining the group is consistent with the IASB's forthcoming Exposure Draft of a revised *Conceptual Framework*.

Short-term project—topics to consider in the application of the equity method of accounting for joint venture and associate entities

19. In the short-term project, we would work with the supposition that joint ventures and associate entities are not part of the group. That supposition would be supplemented by defining the unit of account as the investment as a whole, and not the individual financial instruments that underlie the investment. The IASB has recently considered the unit of account for some types of quoted investments in paragraph BC6 of its recent Exposure Draft (*ED/2014/4) Measuring Quoted Investments in Subsidiaries Joint Ventures and Associates at Fair Value*:

> The IASB noted that the nature of an entity's relationship with an investee, based on the level of control or influence in that investee, is the relevant characteristic for those investments to be included within the scope of IFRS 10, IAS 27 and IAS 28. As a result, that characteristic (i.e. the level of control or influence) would highlight that the relevant unit of account in those Standards is the investment to which that key characteristic applies, instead of the individual financial instruments that make up the investment.

20. The resource that financial statements are reporting on is an investment in which the entity holds a non-controlling interest (that is, either the joint venture or associate); from the above (Paragraph BC6) the IASB has concluded that the unit of account is the investment as a whole.

21. Using this supposition, we would seek to address some of the application issues that have been highlighted. In addition to the feedback from GPF members, we have summarised application issues in Appendix B of this paper.

22. One of the key issues highlighted by GPF members, which relates to application issues, was that it is often difficult to obtain the information required to prepare the elimination entities, because significant influence does not always provide the ability to obtain the information required. GPF members also noted that the

profits or losses are negotiated on an arm's-length basis; members explained that without control of the investment, transaction prices had to be determined through negotiation with the joint venture partner or other investors of the associate entity.

23. If joint ventures and associates are not controlled and are not part of the group, it calls into doubt whether it is appropriate for the equity method of accounting to require the elimination of transactions between an investor and its joint venture and associate entities—on the basis that these investments are not part of the group. The short-term project could review the following topics:

    (a) the need for eliminations—including 'upstream' and 'downstream' transactions;

    (b) the requirement for consistent accounting policies;

    (c) impairment of associate and joint venture entities; and

    (d) reciprocal transactions.

24. In addressing the application issues, the objective would be to simplify the requirements current required by IAS 28.

Longer-term project—financial reporting of non-controlling investments (including associate and joint venture entities)

25. Following the short-term simplification project, a longer-term project could then seek to address the wide-ranging issues that relate to the financial reporting of non-controlling investments (including associate and joint venture entities). This project would seek to address (a) the appropriate basis for measurement, which will establish the relevance or otherwise of the equity method; and (b) if the equity method survives, whether we even need the notion of significant influence for measurement purposes or whether the equity method applies to all non-controlling interests.

26. Topics for a longer-term project could include:

Topics for a longer-term project

Identification of the financial reporting problem

27. Investors' information needs regarding interests in non-controlling investments (including joint venture and associate entities).

Objective of the equity method of accounting

28. What information does the equity method of accounting provide?

Scope of the equity method of accounting

(a) application of the equity method of accounting for non-controlling interests;

(b) definition of an associated entity;

(c) meaning of significant influence

Measurement options for joint ventures and associates investments

(a) fair value;

(b) cost; or

(c) equity method

Reporting financial performance for joint ventures and associates investments

(a) reporting changes in fair value; and

(b) performance reporting when applying the equity method—reporting of earnings and tax.

29. It is also foreseeable that the timing of a longer-term project could be linked to the Post-implementation Reviews of IFRS 10, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interest in Other Entities*. The findings in relation to the disclosure set out in IFRS 12 will be particularly relevant.

Question 1 for ASAF members

We are seeking the views on ASAF members on whether the Equity Method of Accounting research project should be separated into:

(a) a short-term project that has the objective of addressing application issues by simplifying the current requirements in IAS 28 for investments joint venture and associate entities;

(b) following this, a longer-term project that has the objective of reconsidering more fundamentally the financial reporting of investments in entities that do not give the investor control of the entity (including interests in joint ventures and associate entities).

The equity method in separate financial statements

30. In relation to separate financial statements, we think that the KASB research report provides some very useful insights on the equity method of accounting in separate financial statements; in particular Chapter 4 on the experiences of the equity method under Korean GAAP.

31. In its report the KASB notes that:

> In 1998 K-GAAP was amended to establish the equity method as one of the accounting treatments for "investment security". The purpose of the amendment was to bring the effect of consolidation into the stand-alone financial statements. As a result, in addition to the existing requirement, the equity method was required (1) for both associates and subsidiaries and (2) in the stand-alone financial statements.

32. The research report notes that diverse issues arose in practice that could not be resolved by its previous principles applied to the equity method when applied in consolidated financial statements.

33. In 2004 *The Statement of Korean Accounting Standards of Equity Method* was issued. This introduced an equity method exclusively for subsidiaries, which was different from the equity method for associates. The equity method account for

subsidiaries in Korean GAAP aligns net profit or loss and net assets in the consolidated financial statements, with the exception of when the losses of investees exceed their carrying value.

34. The KASB has introduced distinct rules to make the effect of the equity method for subsidiaries the same as when it is applied to consolidation. As a consequence, there is a difference between the equity method for subsidiaries and the equity method for joint venture and associates entities. Paragraph 189 of the research report sets out the following differences:

    (a) Elimination of unrealised profits/losses in downstream transactions. The unrealised profit or loss that occurs through downstream transactions between investors and subsidiaries is fully eliminated, while it is eliminated at the proportion of the investor's interest in the equity method for associates.

    (b) Acquisition and disposal of subsidiary's shares, if that does not affect the status between the investor and the subsidiary.

    (c) Changes in a subsidiary's equity due to the issuance of new shares and other equity transactions without a change of control.

    (d) Investor's recognition of the impairment of the account balances incurred from the transactions between the investor and subsidiaries.

    (e) The accounting for obtaining control through the additional acquisition of shares.

35. In current IFRS for separate financial statements, we think that application of the equity method of accounting for investments in subsidiaries is used as pseudo-consolidation (or one-line consolidation). The KASB research report also implies that in separate financial statements, the equity method of accounting has a pseudo-consolidation role for subsidiaries.

Question 2 for ASAF members:
As a consequence of the analysis above, we are seeking ASAF members' views on whether the Equity Method of Accounting research project should consider separately the equity method of accounting in separate financial statements for subsidiary entities.

Appendix A

Summary of Korea Accounting Standards Board research report—The Equity Method

Introduction

A1. In September 2014 the Korea Accounting Standards Board (KASB) published a research report on The Equity Method; this Appendix provides a high level summary of that report.

A2. The research report was also discussed at the Accounting Standards Advisory Forum in December 2014.

Overview of the KASB research paper

A3. The objective of the KASB research report was to present issues that the IASB should consider in amending IAS *28 Investments in Associates and Joint Ventures*, as well as presenting possible tentative ways to resolve ongoing issues regarding the equity method of accounting.

Chapter 1

A4. The research report explores the confusion that exists regarding the concept of the equity method. It discusses the two viewpoints regarding the concept of the equity method; that is, whether the equity method is a consolidation technique or a measurement basis for an investment.

Chapter 2

A5. The first part of this chapter discusses the historical use of the equity method. It concludes that application of the equity method to subsidiaries clearly shows that consolidation is part of the concept of the equity method. However, the application of the equity method to non-subsidiaries in the consolidated financial statements, and the application of the equity method to both subsidiaries and non-subsidiaries in the separate financial statements, make it unclear whether the concept of the equity method is a consolidation or a measurement basis.

A6. The second part compares and contrasts the equity method of accounting as applied in German GAAP, US GAAP and Korean GAAP. The comparison of

the equity method as applied under three different national GAAPs demonstrates that there is no 'single equity method'. It notes in Germany and Korea the equity method is a substitute for consolidation, whereas in US GAAP the equity method is focused on measurement.

Chapter 3

A7. This chapter considers a new dimension, 'scope of equity-accounted group', to define the underlying concepts of the equity method. The scope of the equity-accounted group is determined by the extent of inclusion of the associates in the investor's equity-accounted group. The paper explores the scope of the equity-accounted group by including the associate as a whole, the associate as part of the group, or not part of the group. Under all three alternatives, the associate is presented in one line in the investor's financial statements as an equity-accounted investment. However, depending on the differences in the scope of the equity-accounted group, the accounting treatments and the results differ.

Chapter 4

A8. This chapter explains how, before the adoption of IFRS, companies in Korea had used stand-alone financial statements as the primary financial statements, and the equity method had been applied to account for associates and subsidiaries in the stand-alone financial statements. It is explained that Korean GAAP has an equity method of accounting for subsidiaries and a different equity method of accounting for associates. The Korean equity method for subsidiaries aligns net profit or loss and net assets of the subsidiary in the parent's stand-alone financial statements with the parent's share of the net profit or loss and net assets in the consolidated financial statements.

Chapter 5

A9. This chapter provides empirical evidence of the relative usefulness of the equity method and the cost method, using listed companies on the Korean stock market. The KASB conclude that when the parent company has associates, equity method financial statements provide more value information than cost method financial statements.

Appendix B—Application issues related to the equity method of accounting

Application issue	Description
Acquisition of an Interest in a Joint Operation Amendment issued May 2014.	The IASB amended IFRS 11 *Joint Arrangements* to clarify that acquirers of an interest in a joint operation that constitutes a business shall apply the relevant principles on business combination accounting in IFRS 3 *Business Combinations* and other Standards, and disclose the relevant information specified in these Standards for business combinations.
Separate financial statements: use of the equity method Amendment issued August 2014.	This narrow-scope project restored the option to use the equity method of accounting in a parent entity's separate financial statements for its subsidiaries.
IFRS 10 and IAS 28 (2011): Sale or Contribution of Assets between an Investor and its Associate or Joint Venture Amendment issued September 2014.	The amendments address an acknowledged inconsistency between the requirements in IFRS 10 and those in IAS 28 (2011), in dealing with the sale or contribution of assets between an investor and its associate or joint venture. 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.
Application of the equity method by a non-investment-entity investor to an investment entity investee Amendment issued December 2014.	The amendments clarify: (a) which subsidiaries of an investment entity are consolidated in accordance with paragraph 32 of IFRS 10. (b) the exemption to present consolidated financial statements, set out in paragraph 4 of IFRS 10, is available to a parent entity that is a subsidiary of an investment entity. (c) how an entity that is not an investment entity should apply the equity method of accounting for its investment in an associate or joint venture that is an investment entity.
Transactions between an Entity and its Associate or Joint Venture (Proposed amendments to IFRS 10 and IAS 28) Exposure Draft due to be issued Q2 of 2015.	The objective of this project is to clarify: (a) 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 the joint venture; (b) how an entity accounts for a contribution to its associate or joint venture when the entity receives assets in addition to receiving an equity interest ; and

Application issue	Description
	(c) whether the cost of an associate or a joint venture should be before or after eliminated gains for the purposes of calculating any difference between cost and the investor's share of net assets on acquisition'.
Equity Method: Share of Other Net Assets Changes	The objective of the proposed amendments was to provide additional guidance to IAS 28 on the application of the equity method, a method of accounting whereby the investment is initially recognised at cost and subsequently adjusted to reflect the change in the investor's share of the investee's net assets. The ED did not proceed to a Standard.
Associates and common control	The issue considered is 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.
IAS 28: Assessment of significant influence: Fund manager acting as agent and holding own investment in the fund IFRIC issue on hold	The Interpretations Committee 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. The submitter described a particular situation in which an assessment of control under IFRS 10 resulted in the conclusion that the fund manager does not control the fund that it manages and in which it has a direct holding, because it is acting as an agent in accordance with paragraphs B58–B72 of IFRS 10.
IAS 28: When associates issue preference shares (KASB research report)	The current simple requirements with regard to preference shares, which have a variety of entitlements to net profit distribution, has led in practice to diverse accounting treatments.
IAS 28: Impairment of associates and reversal of impairment (KASB research report)	IAS 28 requires an investor to follow IAS *39 Financial Instruments: Recognition and Measurement* in identifying indicators of impairment. Whenever application of the requirements of IAS 39 indicate that the interest in as associate or a joint venture may be impaired, the entire carrying amount of the investment is tested as a single asset under IAS 36 *Impairment of Assets*.
IAS 28: Allocation of impairment loss (KASB research report)	Under IAS 28, the investor's share of the associate's other comprehensive income is not reversed when it recognises the impairment loss of the associate. Then, even if the investor recognises the impairment loss up to the total book value of the associate, its share of accumulated other comprehensive income is still presented in the investor's statement of financial position.

Application issue	Description
IAS 28: Reciprocal interest (KASB research report)	The reciprocal holdings might give rise to a measure of double-counting of profits or losses and the equity between the investor and its associate.