IFRS

STAFF PAPER

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Project	**Equity Method**
Paper topic	Research findings

CONTACT(S) Filippo Poli fpoli@ifrs.org
Hazirah Hasni hhasni@ifrs.org

Purpose of the paper

1. At its October 2021 meeting, the International Accounting Standards Board (IASB) decided the staff should undertake research before considering the application questions in the scope of the Equity Method project.[1]

2. This paper summarises the findings of that research. This paper is for information and the IASB is not asked to make any decisions.

Structure of the paper

3. The paper is structured as follows:

   (a) summary of the findings (paragraphs 4–10 of this paper);

   (b) the Conceptual Framework project—the reporting entity (paragraphs 11–15 of this paper);

   (c) the Business Combinations project (paragraphs 16–34 of this paper);

   (d) the Joint Arrangements project (paragraphs 35–41 of this paper); and

[1] See AP13 of the October 2021 IASB Meeting and the IASB Update October 2021.

(e) question for the IASB.

Summary of the findings

4. The staff focused its research on projects whose objectives were to improve IFRS Accounting Standards for interests in other entities because these changes may be relevant to how the equity method is applied and to help develop solutions for the application questions in the Equity Method project.

5. In addition to projects related to interests in other entities the staff considered the Conceptual Framework project as it describes the objectives of, and the concepts for, general purpose financial reporting. The staff thinks the economic entity perspective under which financial statements are prepared from the perspective of the reporting entity as a whole and not a particular group of the entity's investors could be relevant to the Equity Method project.

6. The economic entity perspective in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework)* is consistent with some of the changes introduced in the Business Combinations project such as the measurement and presentation of non-controlling interests, changes in the level of ownership in a subsidiary and business combinations achieved in stages.

7. In its Joint Arrangements project the IASB removed a choice of accounting for interests in jointly controlled entities—eliminating proportionate consolidation. IFRS 11 *Joint Arrangements* requires a joint venturer to measure an investment in a joint venture using the equity method.

8. In the Joint Arrangements project the IASB also concluded that obtaining or losing significant influence or joint control is fundamentally different from obtaining or losing control. The IASB characterised obtaining or losing control as a significant economic event, because it modifies the boundaries of the group as defined in IFRS 10 *Consolidated Financial Statements*. This characterisation explains the remeasurement of any previously held or retained interests in the investee when obtaining or losing control.

9. The IASB did not consider revisions to the equity method in any of the projects noted above. The description of the equity method and the definition of significant influence in paragraph 3 of IAS 28 *Investments in Associates and Joint Ventures* were retained. Also, the IASB did not amend the requirement in paragraph 26 of IAS 28 which states that many procedures that are appropriate for the equity method are similar to consolidation procedures.

10. The staff did not focus its research on the Consolidation project, whose objective was to develop a single basis for consolidation and robust guidance for applying that basis.[2] The staff thinks the Consolidation project is not relevant to the application questions in the Equity Method project, because the Equity Method project is not expected to reconsider whether significant influence should be the basis of when to apply the equity method.

The Conceptual Framework—the reporting entity

11. In the July 2006 Discussion Paper *Preliminary views on an improved Conceptual Framework: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information*, the IASB expressed its preliminary view that the entity perspective should be adopted—that is, financial reports should reflect the perspective of the entity. The entity perspective differs from the parent company approach, under which the financial reports reflect the perspective of the entity's owners.[3]

12. In the May 2008 Discussion Paper *Preliminary views on an improved Conceptual Framework for Financial Reporting: The Reporting Entity,* the IASB discussed three approaches to determine the composition of the reporting entity and expressed the preliminary view that the area of business activity is circumscribed by the extent of an entity's control over other entities.

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[2] See paragraph BC29 of the Basis for Conclusions of IFRS 10 *Consolidated Financial Statement*.
[3] This is inferred from the the measurement and presentation of non-controlling interests in IFRS 10 *Consolidated Financial Statements*.

13. As explained in paragraph BC3.10 of the Basis for Conclusions of the *Conceptual Framework*, the IASB specified the entity perspective is adopted in financial statements. Paragraph 3.8 of the *Conceptual Framework* states that financial statements provide information about transactions and other events viewed from the perspective of the entity as a whole. The perspective adopted has implications for consolidated financial statements and for determining the distinction between liabilities and equity.[4]

14. The *Conceptual Framework* also discusses the key features of a reporting entity. The *Conceptual Framework* describes a reporting entity as an entity that is required or chooses to prepare financial statements, without expanding the description. In determining the boundary of a reporting entity that is not a legal entity and does not comprise only legal entities linked by a parent-subsidiary relationship, the focus should be on the information needs of the primary users of the financial statements. Those users need relevant information that faithfully represents what it purports to represent.[5]

15. In developing the *Conceptual Framework*, the IASB:

    (a) did not address the equity method (paragraph 0.17 of the Basis for Conclusions of the *Conceptual Framework*).

    (b) considered whether the *Conceptual Framework* should explain the notions of joint control and significant influence. The IASB decided not to embed these notions in the *Conceptual Framework* and did not discuss whether these notions should continue to play a role in standard-setting (paragraph 3.26 of the Basis for Conclusions of the *Conceptual Framework*).

    Therefore, the IASB did not consider if, and how, the entity perspective or the reporting entity could affect the application of the equity method.

[4] See paragraph BC1.9 of Discussion Paper, *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* issued in July 2006.
[5] See paragraphs 3.10–3.14 of *Conceptual Framework for Financial Reporting*.

The Business Combinations project

16. In March 2004 the IASB issued IFRS 3 *Business Combinations* that replaced IAS 22 *Business Combinations.* In January 2008 the IASB issued a revised IFRS 3.

17. The table below illustrates changes resulting from the Business Combinations project that may be relevant to applying the equity method:

Topic	IAS 22	IFRS 3 (2004)	IFRS 3 (2008)
Business combination achieved in stages	No remeasurement of previously held interest if benchmark treatment applied	Measure fair value of assets and liabilities at each step of the acquisition and recognise excess of consideration over fair value as goodwill	Remeasure previously held interests in the acquiree at its acquisition date fair value and recognise resulting gain or loss in profit or loss
Change in level of ownership	No requirements		Adjust the controlling and non-controlling interest. Recognise the difference between the fair value of the consideration paid (or received) and the change in non-controlling interest in equity.
Presentation of non-controlling interest	Separately from liability and equity	As part of equity	
Measurement of non-controlling interest	**Benchmark treatment:** Pre-acquisition carrying amounts **Alternative treatment:** Proportionate share of the fair value of the acquiree's net assets	Proportionate share of the fair value of the acquiree's net assets	▪ Fair value; or ▪ Proportionate share of the fair value of the acquiree's net assets
Measurement of consideration	Cash and cost directly attributable to acquisition	Fair value of net assets and cost directly attributable to acquisition	Fair value of net assets. Costs directly attributable to acquisition are expensed.

IFRS 3 and the economic entity approach

22. IFRS 3 issued in 2008 does not explicitly refer to any consolidated financial statement theory, however some of the requirements (when comparing to IAS 22 and IFRS 3 as issued in 2004) reflect an economic entity approach. Examples include the requirements for:

    (a) the measurement and presentation of non-controlling interests;

    (b) changes in the level of ownership in a subsidiary; and

    (c) business combinations achieved in stages.

23. The implicit use of the economic entity approach was confirmed in a December 2006 IASB staff paper.[6] The staff paper illustrated the procedures that would be applied under the different theories about the reporting entity.

Measurement and presentation of non-controlling interests

24. Applying an economic entity approach, consolidated financial statements are prepared from the entity's perspective. The implication of this is that the share of the acquiree's net assets attributable to the controlling interest and non-controlling interests should both be measured at the same amounts.

25. Since the non-controlling interests represent the residual interest in the assets and liabilities of the subsidiaries recognised in the consolidated financial statements, the non-controlling interests are considered to be part of equity[7] and consequently reported as a separate component of equity[8] (and not as liabilities).

Changes in the level of ownership in a subsidiary

26. Applying the economic entity approach, changes in controlling and non-controlling interests are viewed as transactions with owners in their capacity as owners, similar to transactions of own shares.[9] This means that no gain or loss from these changes should

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[6] See Agenda Paper 8A of the December 2006 IASB meeting.
[7] See paragraphs BCZ159 and BCZ161 of the Basis for Conclusions of IFRS 10 *Consolidated Financial Statement*.
[8] See paragraph 22 of IFRS 10 *Consolidated Financial Statement*.
[9] See the explanatory note on the Accounting for changes in the relative proportion of the controlling and non-controlling interests (ifrs.org)

be recognised in profit or loss and also that no change in the carrying amount of the subsidiaries assets or liabilities should be recognised as a result of these transactions.

27. The IASB reached the conclusion that no gain or loss should be recognised in profit or loss because it believed that this approach was consistent with the previous decision that non-controlling interests are a separate component of equity.[10]

28. The IASB also concluded that no change in the carrying amount of the subsidiaries assets or liabilities should be recognised because the wealth-generating ability of the investee's assets is unaffected when the owner purchases (or sells) additional shares from non-controlling interests. Rather, the owner with controlling interest is merely acquiring more rights (or less rights) to the income from the assets it already controls. [11]

Business combinations achieved in stages

29. IFRS 3 as issued in 2008 requires an acquirer to remeasure previously held interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss in profit or loss or other comprehensive income. Under the economic entity approach, all the subsidiary's assets including goodwill are considered to have been acquired at the time the entity acquires control and are measured at the same acquisition date fair values.

30. Paragraph 384 of the Basis for Conclusions of IFRS 3 explains that a change from holding a non-controlling interest in an entity to obtaining control of the entity is a significant change in the nature and economic circumstances surrounding the investment.

31. The IASB concluded that as the acquirer ceases accounting for the previously held interest and starts accounting for the acquiree's assets and liabilities the event should be treated as if the investor had disposed of the previously held interest and acquired the controlling interest. As a consequence, the investor should include the acquisition-date fair value of the previously held interest in the measurement of the consideration.

32. Further, the IASB noted that the requirement to remeasure previously held interest in an acquiree eliminates cost accumulation in business combinations achieved in

[10] See paragraph BCZ169 of the Basis for Conclusions of IFRS 10 *Consolidated Financial Statement*.
[11] See paragraph BCZ174 of the Basis for Conclusions of IFRS 10 *Consolidated Financial Statement*.

stages—which in practice has led to many inconsistencies and deficiencies in financial reporting.[12]

33. The revision to IFRS 3 in 2008 to require remeasurement of previously held interest in acquiree at fair value and recognise any resulting gain or loss in profit or loss[13] meant an acquirer could no longer recognise goodwill at each step of an acquisition, as it previously could in a cost accumulation approach. Rather, the date control is obtained acts as the single measurement date for the purposes of recognising and measuring goodwill.

34. The IASB also categorised loss of control as a significant economic event, as explained in paragraph BCZ182 of the Basis for Conclusions of IFRS 10.

The Joint Arrangements project

Removing proportionate consolidation

35. In September 2007, the IASB issued Exposure Draft *Joint Arrangements.* The IASB proposed removing the option to account for interests in joint ventures using proportionate consolidation. The IASB explained that when a party to an arrangement has joint control over an entity, using proportional consolidation results in the recognition of assets that the party does not control and liabilities for which the party has no obligation.

36. The IASB proposed that when a party to an arrangement has contractual rights to individual assets or contractual obligations for individual liabilities, the party would recognise the assets and liabilities in accordance with the applicable IFRS Accounting Standard.

37. Joint venturers were required to measure the interest in a joint venture using the equity method. The IASB explained that the equity method is a method that accounts for the venturer's interest in the net assets of the joint venture, without reconsidering further the equity method or discussing alternative measurement.

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[12] See paragraph BC386 of the Basis for Conclusions of IFRS 3 *Business Combinations.*
[13] See paragraph 32 of IFRS 3 *Business Combinations*.

Loss of joint control or significant influence

38. When the IASB issued the 2007 Exposure Draft *Joint Arrangements*, the IASB characterised the loss of joint control or significant influence as a significant economic event, and therefore proposed that, when an investor loses joint control, it would remeasure any retained interest at its fair value at that date.

39. However, an investor that loses joint control but retains significant influence, would continue applying the equity method. The IASB explained that it would readdress this aspect when it reconsiders the use of the equity method.

40. The IASB later reconsidered the characterisation of the loss of significant influence during its redeliberation of the 2007 Exposure Draft. Paragraph 28 of the Basis for Conclusions of IAS 28 explains that the loss of joint control or significant influence, although significant, is different from the loss of control because the composition of the group is unaffected. However, the IASB retained the requirement to remeasure any retained interest in the former associate, because the IASB noted that IFRS 9 *Financial Instruments* would require measuring equity instruments at fair value on initial recognition.

41. The IASB also retained the requirement that an investor does not remeasure its interest when it loses joint control while acquiring significant influence or loses significant influence while acquiring joint control. The IASB acknowledged that the investor-investee relationship changes and, consequently, so does the nature of the investment. However, considering that there is neither a change in the group boundaries nor a change in the measurement requirements, the IASB concluded that losing joint control and retaining significant influence is not an event that warrants remeasurement of the retained interest.[14]

Question for the IASB

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Do IASB members have comments or questions on the above summary?

[14] See paragraph BC30 of the Basis for Conclusions of IAS 28 *Investments in Associates and Joint Ventures*