Staff paper

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IASB® meeting

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Project	**Equity Method**
Topic	**Towards an Exposure Draft—Project scope**
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Introduction and purpose of this paper

1. The purpose of this paper is to ask the International Accounting Standards Board (IASB) whether to extend the scope of the Equity Method project (project scope) for three application questions.

2. At its meeting in March 2021, the IASB agreed on a process for selecting the application questions to be included in the project scope. The process is summarised in the appendix to this paper. When applying the process, there were three application questions with recurrent themes that were excluded from the project scope. The staff said they would bring these application questions to a future meeting so that the IASB could decide whether to add them to the project scope.

Staff recommendation

3. The staff recommend the IASB:

   (a) to retain the project's scope; and

   (b) to ask in the invitation to comment on the exposure draft whether the IASB should seek views in its next agenda consultation on adding to its work plan a project on assessing the rights that currently give an investor access to returns when applying IAS 28 *Investments in Associates and Joint Ventures*.

Structure of this paper

4. This paper is structured as follows:

   (a) how application questions were selected (paragraphs 5–7 of this paper);

   (b) application questions with recurrent themes:

      (i) ownership interests that currently give access to returns, paragraph 13 of IAS 28 (paragraphs 8–18 of this paper);

      (ii) reciprocal interests (paragraphs 19–32 of this paper); and

      (iii) non–coterminous reporting date and dissimilar accounting policies (paragraphs 33–40 of this paper);

   (c) staff conclusions (paragraphs 41–44 of this paper);

   (d) question for the IASB; and

   (e) Appendix—Process for selecting the application questions to be included in the scope of the Equity Method project.

How application questions were selected

5. Agenda Paper 13 of the March 2021 meeting explained that national standard-setters, accounting firms and regulators were asked for views on potential application questions and whether there were other application questions the IASB should include in the scope of the Equity Method project. Based on their replies, potential application questions were added to the list. The process summarised in the appendix to this paper was then applied to the list. The application questions meeting the selection criteria were included in scope of the project[1].

6. As noted in paragraph 2 of this paper, there were three application questions with recurrent themes that were excluded from the scope of the project.

7. The excluded application questions were:

   (a) How does an investor assess, in accordance with paragraph 13 of IAS 28, the circumstances in which it has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest;

   (b) How does an investor apply the equity method as set out in IAS 28, when an associate holds an interest in the investor (reciprocal interests); and

   (c) How does an investor apply the requirements in paragraphs 34 and 36 of IAS 28, when an associate has a non-coterminous reporting date or uses accounting policies other than those of the investor for like transactions and events in similar circumstances.

[1] The application questions retained are included in Appendix B Table B2 of AP13 *Towards an Exposure Draft—Cover paper* of this meeting.

Application questions with recurrent themes

Applying paragraph 13 of IAS 28—ownership interests that currently give access to returns

8. An investor applies paragraphs 5–9 of IAS 28 to assess whether it has significant influence of an investee. In making this assessment, an investor takes into consideration the existence and effect of potential voting rights, currently exercisable or convertible, that give an investor additional voting rights or reduce another party's voting power (paragraph 7 of IAS 28).

9. An investor, having determined it has significant influence, applies paragraphs 12–13 of IAS 28 to decide those ownership interests to which the equity method is applied.

10. Paragraphs 12 of IAS 28 states:

> When potential voting rights or other derivatives containing potential voting rights exist, an entity's interest in an associate or a joint venture is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivative instruments, unless paragraph 13 applies.

11. Paragraph 13 of IAS 28 states:

> In some circumstances, an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest. In such circumstances, the proportion allocated to the entity is determined by taking into account the eventual exercise of those potential voting rights and other derivative instruments that currently give the entity access to the returns.

12. The application question in paragraph 7(a) of this paper asks the IASB to clarify the circumstances in which paragraph 13 of IAS 28 applies. Those responding to the request on the application questions to be included in the scope of the project said there are different accounting practices for frequently used financial instruments, such as redeemable preference shares.

Current accounting practices

13. The manuals published by the four largest accounting firms state that an investor should consider a range of factors in assessing if an instrument provides access to the returns associated with ownership. These factors include a comparison of the rights and returns of the instrument to the right and returns of ordinary shares, including:

    (a) whether the instrument participates in earnings and capital appreciation;

    (b) whether the instrument has a similar subordination as the ordinary shares;

    (c) whether the instrument has a conversion feature into an ordinary share; and

    (d) what are the terms and conditions for the conversion, such as the price formula, restrictions on dividend distribution before the exercise or adjustment of the price with respect of distributions.

Why the application question was not selected

14. In determining what the selection criteria should be, the IASB decided it would exclude application questions that cannot be solved without fundamentally rewriting IAS 28 (see the second selection criterion in the appendix in this paper). Applying this criterion, the question in paragraph 7(a) of this paper was excluded from the project scope.

15. Furthermore, the third selection criterion in the selection process excludes application question that could not be solved without amending other IFRS Accounting Standards. The requirements in paragraphs 12–13 of IAS 28 are similar to those applicable to subsidiaries in paragraphs B89–B90 of IFRS 10 *Consolidated Financial Statements*.

16. In applying the third selection criterion, the staff were concerned that answering this application question could affect the application of paragraphs B89–B90 of IFRS 10. The staff noted that although during the Post-implementation Review of IFRS 10 some respondents asked for further guidance to help assess control, no concerns were raised on the application of paragraphs B89–B90 of IFRS 10.

Staff analysis

17. In the staff's view solving the application question in paragraph 7(a) of this paper would pose the following challenges:

    (a) none of the principles identified as underlying IAS 28[2] or the IASB's tentative decisions in the project[3] would help to solve this application question;

    (b) finding a solution that applies to a wide range of financial instruments without adding detailed requirements for individual financial instruments to IAS 28; and

    (c) assessing the possible implications to IFRS 10.

18. Consequently, the staff do not recommend extending the scope of the project to address this question. We agree that applying paragraphs 12–13 of IAS 28 to financial instruments that give an investor potential voting rights requires judgement to decide if those interests should be interests to which the equity method is applied.

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[2] See Appendix A of AP13 *Towards an Exposure Draft—Cover paper* of this meeting.

[3] Access the summary of the IASB's tentative decisions.

Reciprocal interests

19. A reciprocal interest, also known as crossholding, occurs when two entities hold interests in each other. The application question in paragraph 7(b) of this paper refers to an associate that holds an interest in its investor or another entity in the investor's group, or two entities that hold an interest that provides significant influence in each other.

20. When an associate holds an interest in its investor, the investor's share of its associate's net assets includes its own shares. IAS 28 does not include requirements on whether the investor recognises the shares held by the associate as own shares, or whether an investor eliminates gains or loss recognised in profit or loss related to its own shares. An associate's profit or loss includes gains and losses arising on the investor's own shares either because the associate measures its interest in the investor either at fair value with changes recognised in profit or loss,[4] or using the equity method. In either case, the investor's share of the associate's profit or loss includes changes in the carrying amount of the investor's own shares.

21. In consolidated financial statements a corresponding question, on how to measure an interest held by a subsidiary in its parent, is addressed in paragraph 33 of IAS 32 *Financial Instruments: Presentation* that requires if an entity acquires its own equity instruments, those instruments should be deducted from equity and goes on to refer to treasury shares held by other members of the consolidated group. The IASB's rationale to recognise the reporting entity's own shares in equity is that the acquisition and subsequent sale of own equity instruments represents a transfer between the holders of equity instruments, rather than a gain or loss to the entity.

[4] IFRS 9 *Financial Instruments* allows an irrevocably election to measure an investment in equity instruments at fair value with the changes in other comprehensive income.

Why the application question was not selected

22. The first criterion in the selection process was whether the question had been solved by the IASB or the IFRS Interpretation Committee (the Committee). In relation to reciprocal interests, the Committee discussed two issues at its April 2003 meeting:

    (a) How an entity in its consolidated financial statements measure non-controlling interest, if its shares are held by that subsidiary?

    (b) How should an investor account for its shares held by an equity method investee?

23. In relation to the issue in paragraph 22(a) of this paper, the Committee considered whether the parent should measure the non-controlling interest before or after deducting its shares held by the subsidiary from the consolidated equity. The Committee agreed with the staff analysis presented at its meeting that the parent would deduct a portion of its shares from the non-controlling interest. The staff analysis was based on the subsidiary's net assets being viewed from the consolidated entity's perspective. This was based on amendments proposed by the IASB to improve IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* that included:

    (a) consolidated financial statements are the financial statements of a group presented as those of a single economic entity; and

    (b) intragroup balances, transactions, income and expenses shall be eliminated in full.

24. The IASB included these requirements when it issued a revised IAS 27 *Consolidated and Separate Financial Statements* in December 2003, and the requirements were carried over to IFRS 10.[5]

[5] See the definition of consolidated financial statements in Appendix A of IFRS 10 *Consolidated Financial Statements* and paragraph B86(c) of IFRS 10 for intragroup eliminations in consolidation procedures.

25. In relation to the issue in paragraph 22(b) of this paper, the Committee agreed with the staff analysis presented at its meeting that an investor should reduce its equity (and its investment in the associate) in its consolidated financial statements for the investor's proportionate interest in its own shares held by the associate. The Committee decided to wait until the amendments to improve IAS 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* were finalised from the Business Combinations Phase II project before considering whether to add this issue to its agenda.

26. After the Agenda Decision was published[6], neither the Committee nor the IASB took further action on the accounting for reciprocal interests. In applying the selection criteria in the appendix to this paper, the staff's initial view was that this issue had been resolved by the Committee discussion in March 2003.

Staff analysis

27. The basis for the Committee's decision in April 2003 on how an investor accounts for its shares held by an equity method investee, was the application of what is now paragraph 26 of IAS 28 which states:

> Many of the procedures that are appropriate for the application of the equity method are similar to consolidation procedures described in IFRS 10…

[6] August 2002/April 2003, Agenda Decision 'Reciprocal Interests'.

28. Since the Committee discussed this matter the IASB has completed its Business Combinations phase II, Consolidation and Joint Arrangements projects. These projects introduced new requirements for reporting interests in other entities. In addition, the IASB has issued a revised *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). At the April 2022 IASB meeting, the staff presented an analysis to explain how the changes introduced in IFRS Accounting Standards by these projects could be relevant for the application questions in the scope of the Equity Method project.

29. Agenda Paper 13B[7] of the April 2022 meeting noted that:

    (a) the *Conceptual Framework* had adopted the entity perspective in financial statements. The entity perspective differs from the parent company perspective, under which the financial reports reflect the perspective of the entity's owners. An entity perspective has implications for, among others, the measurement and presentation of non-controlling interests.

    (b) in the Joint Arrangements project the IASB 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 that modifies the boundaries of the group, as defined in IFRS 10.

    (c) IFRS 10 applies the entity perspective in consolidated financial statements.

30. In the staff's view, answering the application question would require the IASB to decide whether paragraph 26 of IAS 28 requires an entity to apply, by analogy, the requirements in paragraph 33 of IAS 32, which requires treasury shares held by the entity or by other members of the consolidated group to be deducted from equity. To do so, the IASB would need to decide if paragraph 33 of IAS 32 is a 'consolidation procedure'.

[7] See AP13B *Research findings* of the April 2022 IASB meeting.

31. The staff believe that before the IASB could make this decision, it would need to assess whether changes in IFRS Accounting Standards from the projects listed in paragraph 28 of this paper affected the staff analysis and the views of the Committee from 2003. We think it would be difficult for the IASB to complete this assessment without fundamentally considering the nature of the equity method, which is beyond the scope of this project.

32. Consequently, whilst we have changed our view on why the application question should be excluded from the scope of the project (in that we now consider the application question fails the second selection criterion in the appendix to this paper—that it cannot be addressed without fundamental consideration of IAS 28) the staff still recommend the IASB does not include the application question in the project scope.

Non–coterminous reporting date and dissimilar accounting policies

33. When the associate’s financial statements are prepared at a different reporting date or uses different accounting policies from those used by the investor, IAS 28 requires the investor to adjust the amounts reported by the associate.

34. The application question in paragraph 7(c) of this paper asks how to apply the requirements in paragraphs 34 and 36 of IAS 28 when there are limitations to an investor’s ability to obtain the necessary information. Those raising this question noted that, because an investor does not have control of an associate, it may not be able to obtain the information needed to adjust the amounts included in the financial statements of the associate. Furthermore, they said there may be legal problems in using privileged information when the associate is a listed entity.

35. In the staff’s view the question in paragraph 7(c) does not relate to the requirements in IAS 28, but to the investor’s ability to obtain the information necessary to apply those requirements. We understand that those raising the question are not suggesting removing the requirements but simplifying or introducing an exemption.

36. The requirements in paragraphs 34 and 36 of IAS 28 are similar to the requirements applicable to subsidiaries in paragraphs B87 and B92–B93 of IFRS 10. No concerns about these requirements were raised during the Post-implementation Review of IFRS 10, although the staff acknowledge that the relationship between a parent and its subsidiaries is different to the relationship between an investor and an associate.

Why the application question was not selected

37. The third criterion in the selection process in appendix to this paper is whether the application question can be solved without fundamentally rewriting IAS 28. This criterion generally eliminated application questions on how significant influence is assessed.

38. In considering whether to add this question to the scope of the project, the staff were concerned that attempting to resolve this question would lead to a discussion on whether an investor's inability to obtain information from an associate indicates that the investors does not have significant influence. It could therefore raise questions on how significant influence is assessed.

Staff analysis

39. In the staff's view solving the application question in paragraph 7(c) of this paper would pose the following challenges:

    (a) none of the principles identified as underlying IAS 28 or the IASB's tentative decisions on the project would help to solve this application question;

    (b) it could require the IASB to consider if, and if so how, the investor's ability to obtain financial information from the associate should be part of the assessment of whether the investor has significant influence;

(c) introducing an exemption from the requirements in paragraphs 34 and 36 of IAS 28 would permit alternative accounting methods for the same economic phenomenon. Paragraph 2.29 of the *Conceptual Framework for Financial Reporting* explains that permitting alternative accounting methods diminishes comparability;

(d) when IFRS Accounting Standards include exemptions on the grounds of impracticability[8], the exemptions apply to adjusting the comparative information for prior periods. In this case, introducing an impracticability exemption could affect recognition or measurement requirements; and

(e) introducing an exemption requires identifying circumstances in which the exemption applies, and in turn, may give rise to new application questions.

40. Consequently, the staff still recommend the IASB does include the application question in the project scope.

Staff conclusions

41. In the staff's view, the criteria agreed by the IASB to select the application questions to be included in the scope of the project are still appropriate to achieve the project objective.

42. Since the IASB agreed the application questions in the scope of the project, we have not received any additional evidence or requests to expand the project scope. In the staff's view, at this stage of the project, there should be a high hurdle before expanding the scope of the project.

43. In October 2021, the Accounting Standards Advisory Forum (ASAF) members provided their views on the application questions in paragraph 7 of this paper. In summary:

[8] See for instance paragraph 24 of IAS 8 *Accounting Policies, Changes in Accounting Policies and Errors* and paragraph 43 of IAS 34 *Interim Financial Reporting.*

(a) many ASAF members supported including the question on application of paragraph 13 of IAS 28 (determining the financial instruments that are part of the equity accounted investment);

(b) ASAF members said holdings of reciprocal interests are not frequently encountered, and accounting practice has developed; and

(c) a few ASAF members supported including the question on non-coterminous reporting period in the project scope.

44. To acknowledge the views of ASAF members, the staff recommend the IASB asks in the invitation to comment on the exposure draft whether it should seek views in its next agenda consultation on adding a project to its work plan on assessing the rights that currently give the investor access to returns when applying IAS 28.

Question for the IASB

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 3 of this paper?

Appendix—Process for selecting the application questions to be included in the scope of the Equity Method project