EFRAG Secretariat: Didrik Thrane-Nielsen (Project Director), Robert Stojek

Equity Method of Accounting Issues Paper

Objective

1 The objective of the paper is to provide the source for the discussion of EFRAG CFSS and TEG members in order to receive their views on:

(a) the topics related to the areas excluded from the scope of the IASB Research Project *Equity Method of Accounting* (***the Project***),

(b) proposed alternatives for the solution of one area of application issues/questions, and

(c) the Short Paper Series No. 3 of ASBJ *Perspectives of Equity Method of Accounting* and a related presentation concerning whether the equity method of accounting should be considered as one-line consolidation technique, or rather measurement technique.

Issues for the discussion – excluded recurrent themes

2 The application questions for further IASB discussion, are identified using the selection process explained in **Agenda Paper 06.01**. Some of the application questions, not satisfying the criteria, have been excluded. At a future meeting, the IASB may consider whether these questions warrant extending the scope of the Project.

3 The following application questions have been initially excluded:

(a) Ownership interests that provide access to benefits

(b) Reciprocal interests

(c) Non coterminous reporting period and uniform accounting policies

Ownership interests that provide access to benefits

4 Feedback on the initial list of application questions included that there are challenges in determining which instruments should be considered part of the cost of the investment. Instruments identified include redeemable preference shares/perpetual instruments. Furthermore, questions included whether instruments with different features should be bifurcated and IFRS 9 and IAS 28 applied to the relevant components of the instrument.

5 It was also noted that investees may have several classes of equity shares with varying entitlements to net profits, equity, or liquidation preferences. Some instruments may also have entitlements that vary over the economic life of the investee or change upon reaching determined thresholds. In these circumstances, determining the appropriate percentage of ownership interest may be challenging.

6 In applying the selection process, these questions were excluded because they related to the scope of application of the equity method whereas the project's scope is limited to application questions with the equity method. The Board has directed the staff to undertake a limited-scope project to consider application questions with the equity method.

Reciprocal interests

7 Reciprocal interests occur when an associate or joint venture holds an interest in its investor or an investor's subsidiary. Reciprocal interests can give rise to double counting of net assets between the investor and the associate and IAS 28 does not include guidance on how to address this question.

8 These issues were considered, in April 2003, the IFRS Interpretations Committee which decided not to develop an Interpretation on this issue because paragraph 20 of IAS 28 already requires elimination of reciprocal interests (through application of consolidation concepts). It was noted however that these issues should be reconsidered once the Business Combinations phase II project was finalised.

9 The questions on reciprocal interests were excluded in the selection process because these questions could not be solved without amending other IFRS Standards. That is, they relate to how an investor determines the effective ownership interest needed to apply equity method, however, the project scope is restricted to when applying the equity method.

Non coterminous reporting period and uniform accounting policies

10 Feedback on the initial list of application questions, collected by the IASB Staff, included that an investor may not have sufficient information to comply with the requirements in paragraphs 33–35 of IAS 28 and/or the ability to require the associate to provide the necessary information (i.e. paragraph 33 of IAS 28 requires the financial statements of the associate to be prepared as of the same date as the financial statements of the reporting entity and paragraph 35 of IAS 28 requires an investor to use financial statements of the associate that are prepared using uniform accounting policies for like transactions and events in similar circumstances.

11 These questions were excluded because they could not be solved without fundamentally rewriting IAS 28. The application questions were not related to either clarity or missing requirements; but practical application of IAS 28 requirements.

Questions for EFRAG CFSS and TEG members

12 What are the views of EFRAG CFSS and TEG members on application questions that have recurrent themes but have been excluded from the project in applying the selection process?

Issues for the discussion – Changes in an investor's interest in an associate without a change in significant influence

13 The first application issue/question selected by the IASB for further discussion, is the area where IAS 28 lacks guidance:

An investor acquires an additional interest in an associate with no change in significant influence that is the investor has significant influence both before and after the transaction or event. How does the investor account for the difference, if any, between the consideration paid and the share of net assets acquired - including negative differences?

14 Initially, the analysis relates to the equity method applied to investments in associates in the consolidated financial statements. The IASB Staff expects the IASB to consider whether the analysis needs to be modified when the equity method is applied to:

(a) investments in joint ventures;

(b) investments in associates in the investor's separate financial statements; and

(c) investments in subsidiaries accounted for applying the equity method in the separate financial statements.

15 The following sub-areas have been identified for discussion on accounting for changes in an investor’s interest in an associate with no change in the investor’s significant influence:

(a) increases in the investor’s interest:

(i) how is the increase in the investor’s share in the net assets of the associate measured?

(ii) where is a difference between the consideration paid and the additional share in the net assets of the associate recognised?

(b) decreases in the investor’s interest:

(i) how does the investor measure the portion of its investment in the associate to be derecognised?

(ii) where is any difference between the consideration received and the derecognised portion of the investment in the associate recognised?

(c) both increases and decreases in the investor’s interest:

(i) does the investor remeasure its interest in the associate previously held/retained?

(ii) does the investor reclassify to profit or loss amounts previously recognised in other comprehensive income in relation to the associate?

16 The IASB Staff limited the discussion to the questions in **paragraph 15(a) only** because:

(a) IAS 28 does not include requirements related to the questions **15(a)** and a diversity in practice has been reported;

(b) IAS 28 does not include requirements related to the questions 15(b) however no significant concerns on the lack of guidance or diversity in practice have been reported.

(c) Regarding the question in 15(c)(i), paragraph 24 of IAS 28 may be accordingly (i.e., if an investment in an associate becomes an investment in a joint venture, or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest); and finally

(d) Regarding the question in 15(c)(ii), paragraph 25 of IAS 28 may be accordingly applied (i.e. when the investor’s interest is reduced in an associate without the investor losing significant influence, the investor reclassifies to profit or loss amounts previously recognised in other comprehensive income as if the investor had disposed of the related assets or liabilities, proportionately to the reduction its interest). Moreover, the IASB Staff has assumed that requirements in paragraph 25 of IAS 28 do not apply to increases in the investor’s interest and that there would be no basis for reclassification proportionately to an ‘increase’ in the investor’s interest. Furthermore, there is no change in status in the investment (no change in significant influence) therefore there is no basis for full recycling as considered in paragraph 42 of IFRS 3 Business Combinations.

Accounting for increases in investor's interest

17 The missing principle has been developed by applying similar judgment as required when developing an accounting policy applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, that is considering the applicability of the requirements in IFRS Standards dealing with similar and related issues and the definitions, recognition criteria and measurement concepts in the *Conceptual Framework for Financial Reporting*.

18 The IASB Staff suggests that Principle D should be considered as it deals with similar/related issues (see **Agenda Paper 06-01**). The rationale for considering Principle D would be the investor measures increases in its share of the net assets of an associate in the same way as it measures its initial share of the net assets of the associate. Therefore, the investor would measure the additional share of the net assets of the associate based on the net fair value of the associate's net assets at the transaction date and would apply the following principle (***Revised Principle D***):

> *Fair value at the date that an investor acquires an interest in an associate provides the most relevant information and faithful representation of an associate's identifiable net assets.*

19 The IASB Staff has proposed four alternatives for accounting for increases in an investor's interest in an associate with no change in the investor's significant influence:

	Measurement of increase in investor's share in the net assets	**Recognition of the difference between consideration and net assets' increase**
Alternative 1	Share of net fair value of associate's assets and liabilities	Goodwill (or bargain purchase gain)
Alternative 2	Share of net fair value of associate's assets and liabilities	Profit or loss
Alternative 3	At fair value of consideration paid	No difference arises
Alternative 4	Using book values of the existing share of net assets in investor's financial statements	Profit or loss

20 It should be noted that the difference between the consideration paid and the additional share in the net assets of the associate has not been considered as a contribution to, or distribution from, the investor and therefore be recognised in equity. This is because of Principle C which explains that "an investor's share of an associate's or joint venture's net assets is part of the reporting entity". The acquisition of the additional share in the net assets of the associate may arise from transactions between the associate and other shareholders, which are not transactions with owners in their capacity as owners from the investor's perspective and, therefore, the IASB Staff therefore did not consider recognition of the difference in equity as a possible alternative.

Alternative 1

21 This approach is supported by the principle in paragraph 32 of IAS 28 by analogy that any difference between the investor's share in the net fair value of the investee's identifiable assets and liabilities and the cost of the investment is recognised as goodwill or income (bargain purchase gain).

22 It should be noted that there is no equivalent principle for a piece-meal acquisition because a parent has already recognised 100% of the net assets of a subsidiary on acquiring control.

23 This approach is a cost accumulation method and therefore a mixed measurement of the investor's share of the net assets in the associate would arise. This method was previously criticised for resulting in the acquirer measuring the assets and liabilities of the subsidiary at a mixture of fair values at each acquisition date. IFRS 3 therefore requires, for business combinations achieved in stages, the acquirer to remeasure its previously held equity interest at the acquisition date fair values and to measure net assets acquired at fair value.

Alternative 2

24 This approach is supported by the requirements in paragraphs 5.1.1, 5.1.1A and B5.1.2A of IFRS 9 *Financial Instruments* by analogy that if the fair value of the instrument differs from the transaction price the difference is recognised as a gain or loss (if that fair value is evidenced by a quoted price in an active market for an identical asset or liability (Level 1 input) or based on a valuation technique that uses only data from observable markets).

25 See also a critical comment in paragraph 23, which also applies to Alternative 2.

Alternative 3

26 Alternative 3 is supported by applying the requirements for purchases of assets in other IFRS Standards by analogy, such as IAS 16 *Property Plant and Equipment* and IAS 40 *Investment Property*. For instance, paragraph 6 of IAS 16 defines cost as the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

27 Under this alternative, when the fair value of the consideration exceeds the investor's additional share of the fair value of the net assets of the associate, the excess amount would be allocated among the identifiable net assets. The investor's share of profit or loss after acquisition would include adjustments for the excess of consideration for changes in the identifiable net assets – for example, for depreciation of the excess amount of depreciable assets.

Alternative 4

28 Alternative 4 could be derived by applying the requirement in paragraph B96 of IFRS 10 by analogy, which requires an adjustment to the carrying amounts of relative interests for changes in noncontrolling interests in a subsidiary (i.e., acquiring an additional share in a subsidiary without a change in control).

29 Under this alternative, the measurement of the additional share in the net assets of the associate would be based on the net fair value of the net assets of the associate at the date the investor acquired significant influence plus the post-acquisition changes in the net assets of the associate. These amounts may be different from the amounts reported in the financial statements of the associate itself.

Alternatives 1-4 – Application example

30 In the following example (reproduced from the ASAF Agenda Paper) the following financial information is considered:

(a) At the beginning of Year 1, an investor acquired a share of 20% in an associate for consideration of LC1,100 and obtained significant influence.

(b) The fair value of the net assets of the associate at the acquisition was LC4,400.

(c) The investor recognised its share in the net assets at LC880 and the difference of LC220 between the consideration paid and the amount attributed to its share in the net assets of the associate as goodwill and included it in the measurement of the investment in the associate.

(d) The associate's profit for Year 1 was LC700. Consequently, the book value of the net assets of the associate was measured at LC5,100, while their fair value at LC 5,500.

(e) At the end of Year 1, the carrying amount of the investment in the associate was LC1,240, comprising LC1,020 for the investor's share in the associate net assets and LC220 for the goodwill.

(f) At that time, the investor acquired an additional share of 10%, for an amount of LC650.

31 The transaction explained in point 30(f) above, under four Alternatives, should be recognised as follows in the financial statements of the investor"

	Alt 1	Alt 2	Alt 3	Alt 4
Investment in associate	650	550	650	510
of which - share of net assets	*550*	*550*	*650*	*510*
of which - goodwill	*100*			
Comprehensive income		100		140
Cash	(650)	(650)	(650)	(650)

Questions for EFRAG CFSS and TEG members

32 What are the views of EFRAG CFSS and TEG members on Alternatives 1 to 4, explained in the paragraphs above, and their implications for the accounting for changes in the investor's interest in an associate without a change in significant influence?

Perspectives on the Equity Method of Accounting – ASBJ papers

33 In September 2021, the ASBJ (Accounting Standards board of Japan) issued ASBJ Short Paper Series No. 3 *Perspectives on the Equity Method of Accounting* (the ASBJ Paper). This paper is provided for background as **Agenda Paper 06.06**. Additional, and a related ASBJ presentation is provided for background as **Agenda Paper 06.07**.

34 The ASBJ Paper discusses three main approaches to equity method of accounting i.e.: one-line consolidation; a measurement basis; and a hybrid of these two approaches. In the ASBJ opinion, the equity method required by IAS 28 is neither one-line consolidation nor measurement basis but rather a hybrid approach. Moreover, it's perceived as one-line consolidation, resulting from a deliberate decision of management to obtain significant influence or joint control over an investee, with limited number of exceptions. This approach warrants that such investments are closer to consolidation than to accounting for under IFRS 9 *Financial Instruments.*

Principles explaining exceptions to one-line consolidation

35 Consequently, the ASBJ proposes the following four principles applicable to hybrid approach of equity method of accounting, which would constitute the exceptions to one-line consolidation approach.

36 **Principle 1**: The unit of account for the interest in an associate or a joint venture is the interest itself (that is, an investment in a single asset), rather than the assets and liabilities of the associate or joint venture. The investor shall recognise an asset representing its share of the net assets of the associate or joint venture, and income or expense representing its share of the net profit or loss of the associate or joint venture.

The implications of Principle 1 are fairly consistent with the current requirements in IAS 28.

37 **Principle 2**: Impairment of the interest in the associate or joint venture shall be tested against that interest in its entirety. The carrying amount of the interest may be written down to zero, and no additional liabilities would be recognised unless:

(a) the investor has legal or constructive obligations to absorb the losses; or

(b) the amounts that would otherwise be eliminated (in the case of gains from downstream transactions or dividends) exceed the carrying amount of the interest.

38 IAS 28 does not provide guidance on the accounting for cases where the amounts that would otherwise be eliminated exceed the carrying amount of the investment. Principle 2 would clarify the guidance in IAS 28 for such cases.

39 **Principle 3**: Neither significant influence nor joint control constitutes control of an investee. Accordingly, the accounting requirements related to consolidations for the investor's ownership interests based on the concept of a group (a parent and its subsidiaries) shall not be carried over to the accounting requirements related to the equity method.

40 Paragraph 26 of IAS 28 states that many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. However, it is unclear which procedures should follow the procedures in IFRS 10. Principle 3 would clarify the guidance in IAS 28 by focusing on the accounting requirements for the investor's ownership interests that refer to the concept of a group

41 **Principle 4**: For issues that are not covered by Principles 1 to 3, the accounting requirements related to the equity method shall follow the accounting requirements related to consolidations.

42 Principle 4 would clarify the guidance in IAS 28 by stating that, unless Principles 1 to 3 apply, the equity method of accounting should follow the accounting requirements related to consolidations. While many entities currently may not eliminate the investor's share of the loans or borrowings against the carrying amount of the investment in the associate or joint venture, elimination would be consistent with our view.

43 The detailed analysis of rationale for the principles and their implications, are explained on **Agenda Papers 06.06 and 06.07**.

EFRAG's Position on the approach to equity method

44 EFRAG expressed its opinion regarding the approach to equity method of accounting in EFRAG Short Discussion Series: *The Equity Method: A Measurement Basis or One-Line Consolidation? In that paper, EFRAG noted that:*

(a) The historical development of the equity method was that of a one-line consolidation, reflecting the results of subsidiaries in the financial statements of a parent entity in a time before consolidation had evolved, and when not all controlled companies were consolidated.

(b) However, the recent thinking of the IASB when developing IFRS 3, IFRS 10 and IFRS 11 emphasises the concept of 'exclusive control' in the context of acquiring control and losing control to determine the boundary of a reporting entity and of its assets and liabilities and their consequential accounting. Neither an associate nor a joint venture is controlled by an investor and are therefore not part of the group under IFRS. For these reasons, it could be argued that the equity method cannot conceptually be a one-line consolidation.

(c) As a basis to portray performance of an investment in an associate or a joint venture, some would conclude that the equity method is arguably superior in terms of relevance of information provided by both cost and fair value, for the same reasons these came to be considered inappropriate for holding company financial statements before consolidation. Proponents of this view are likely to believe there are valid arguments to maintain the equity method as a means to account for interests in associates and joint ventures.

(d) A wider agreement on the conceptual underpinnings of the equity method will contribute to improving the quality of financial reporting and assist the standard setting process.

45 The responses to EFRAG's paper

(a) Showed a diversity of views, indicating that there is no common understanding of the purpose or use of the equity method.

(b) There was limited consensus on whether the ideas explored in the paper could be used to clarify the equity method without a wholesale reassessment of its underlying role and some respondents specifically called for such a fundamental rethink. Other respondents thought that more clarity on underlying principles was needed, even if this would not be provided by explicitly identifying the equity method as either a one-line consolidation or a measurement basis.

Accounting for consolidations (acquisitions)

46 The accounting requirements in IFRS 10 *Consolidated Financial Statements* and IFRS 3 *Business Combinations* are based on the notion that obtaining control of another entity is a significant economic event. In the case of step acquisitions, this significant economic event warrants a change in accounting such that all of the investments previously made (regardless of whether accounted for under IFRS 9 or IAS 28) would be remeasured at fair value at the date control is obtained, with any difference recognised in profit or loss.

47 Neither significant influence nor joint control constitutes control of an investee. Therefore, in the ASBJ view, such accounting treatment would not represent the event faithfully. This is because such an accounting treatment has the same effect as if the entity sells the investments, previously made, at fair value at the acquisition date but there was no sell of the previously held investments.

48 Consequently, in the opinion of the ASBJ, in the case of step acquisitions, investments previously made should not be remeasured when the investor obtains control. Instead, the carrying amounts of the investments should be carried forward.

Questions for EFRAG CFSS and TEG members

49 Do you agree that the equity method of accounting should adopt a hybrid approach? Why or why not?

50 Do you have any comments on the principles proposed by ASBJ?