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Equity Method of Accounting
Cover Note

Objective

1 The objective of the session is to:

(a) provide EFRAG FR TEG members with an update on the IASB Research Project *Equity Method* (***the Project***); and

(b) seek EFRAG FR TEG members' views on three alternatives presented by the IFRS Staff on applying the equity method to the purchase of an additional interest in an associate without a change in significant influence.

Background and history of the IASB Project

2 Following its Feedback Statement to the 2011 Agenda Consultation, the IASB decided to add the project on equity method of accounting to the research programme. The IASB justified its decision using the feedback from constituents what included the criticisms related to application of the equity method, its complexities, and inconsistencies. The research was intended to involve a fundamental assessment of the equity method in terms of usefulness and difficulties for preparers.

At its May 2016 meeting, however, the IASB decided to defer the work on the Project until the post-implementation review of IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities* (***the PIR***). The PIR itself has not specifically considered the equity method of accounting. Nevertheless, in the feedback to the PIR, the IASB's constituents expressed their opinion that "*there are practical issues in applying the equity method in accordance with IAS 28 Investments in Associates and Joint Ventures".*

3 Following the feedback received from the PIR on the investors' information needs, the IASB restarted the project. Furthermore, in October 2020, the IASB reconsidered the scope of Project and decided that its objective is to:

> *Assess whether application questions with the equity method, as set out in IAS 28, can be addressed in consolidated and individual financial statements by identifying and explaining principles in IAS 28.*

4 In June 2021, the IASB Staff presented to the IASB a list of principles as underlying IAS 28 requirements. The IASB Staff has also collected application issues / question, and presented their short list, following the application of selection criteria.

5 Regarding these selection criteria, it needs to be noted, that in order to be further considered by the IASB, the application questions would need to be not-yet-solved, possible to solve without fundamentally rewriting IAS 28; possible to solve without amending other IFRS Standards; important - i.e., frequent, widespread, material - and affecting consistent application of IAS 28.

6 The selection criteria also mean that the IASB will not consider fundamental reconsidering of IAS 28 guidance, what may exclude some of the application issues from the scope of the Project.

7 The list of the principles and the short list of issues are provided in Appendices 1 and 2.

8 Apart from the application questions, the IASB Staff identified the following areas, where IAS 28 lacks guidance and consequently principles:

(a) the investor's accounting for the share in the investee's other net asset changes; and

(b) purchases or other increases in the investor's ownership share that do not result in obtaining control of the investee.

Background of EFRAG discussions

9 The identified principles and issues, mentioned above, were discussed at the EFRAG TEG and CFSS meeting in September 2021. At the meeting, the members commented that the scope of the project should be broader. They also favoured an approach where the measurement of increase in investor's share in the net assets would be measured at a share of net fair value of associates assets and liabilities, while the difference would be recognised as goodwill (or bargain purchase). One member however also favoured an approach where the increase in share in net assets would be measured at fair value of consideration paid.

Update on the recent discussions of the IASB

10 In October 2021, the IASB received an update on application questions, and decided that the IASB staff should research the implications of differences between the principles in IAS 28 and those in other IFRS Standards relating to: business combinations and consolidation before considering the application questions.

April 2022 IASB meeting

11 In April 2022, the IASB discussed the research findings on changes made to IFRS Standards arising from the *Conceptual Framework*, and Business Combinations and Joint Arrangements projects. The findings include the comparison of approaches applied to changes in ownership in IAS 22 *Business Combinations* and two versions (2003 and 2008 revised) of IFRS 3 *Business Combinations*. For reference, the detailed finding are available in the April 2022 IASB meeting agenda paper: here.

12 Following the discussion, the IASB decided to consult with stakeholders on measuring the cost of an investment, when an investor obtains significant influence, as the fair value of the consideration transferred, including the fair value of any previously held interest in the investee.

13 Furthermore, at this meeting, the IASB considered three approaches to applying the equity method when an investor purchases an additional ownership interest in an associate without a change in significant influence.

(a) The IASB asked the IASB Staff to proceed with an approach where an investor, that has previously obtained significant influence, would measure the investment in the associate as an accumulation of purchases as a **preferred approach**.

(b) As an **alternative approach**, the IASB Staff will consider an approach where an investor measures its investment in the associate as a single asset.

June 2022 IASB meeting

14 At its June 2022 meeting, the IASB discussed the application of preferred approach to transactions of purchase of an additional interest.

15 The IASB tentatively decided that an investor purchasing an additional interest that is a bargain recognises the bargain purchase gain separately (from any goodwill previously recognised) in profit or loss. However, the IASB has not reached a clear decision on how to accounting for partial disposal and, therefore, asked the IASB Staff to provide a further analysis.

16 Furthermore, the IASB asked their Staff to consult FASB Staff on US GAAP guidance for other changes in an associate's net assets, and to provide an analysis at a coming meeting.

Agenda Papers

17 In addition to this cover note, agenda paper 05-02 – *Equity Method - Issues Paper Explaining three alternative approaches* – has been provided for the session.

Questions for EFRAG FR TEG members
18 Do you have comments on the project update?

Next steps

19 The IASB will consult with its stakeholders on measuring the cost of an investment, when an investor obtains significant influence, as the fair value of the consideration transferred, including the fair value of any previously held interest in the investee. The consultation will be in a form of a discussion paper or exposure draft.

20 Furthermore, the IASB will further discuss how the approach applies to other application questions.

Next steps in EFRAG project

21 EFRAG will monitor the IASB discussion and will provide updates on the decisions.

22 EFRAG also plans to issue a bulletin in Q3/Q4 2022 concerning the possible amendments to equity method of accounting.

Appendix 1. Identified Principles Underlying IAS 28

In June 2021, the following principles, identified by the IASB Staff as underlying IAS 28, were presented to the IASB:

Classification

(a) Principle A — power to participate is an investor's shared power to affect changes in, and to access net assets;

Boundary of the reporting entity

(b) Principle B — application of the equity method includes an investor's share in the associate's or joint venture's net asset changes in an investor's statement of financial position;

(c) Principle C — an investor's share of an associate's or joint venture's net assets is part of the reporting entity;

Measurement on initial recognition

(d) Principle D — fair value at the date that significant influence or joint control is obtained provides the most relevant information and faithful representation of an associate's or joint venture's identifiable net assets;

Subsequent measurement

(e) Principle E — an investor recognises changes in an associate's or joint venture's net assets. An investor recognises the share of changes in net assets that it can currently access;

(f) Principle F — an investor's maximum exposure is the gross interest in an associate or joint venture;

(g) Principle G — when an investor has a decrease in its ownership interest in an associate or joint venture and continues to apply the equity method, it reclassifies amounts previously recognised in other comprehensive income;

Derecognition

(h) Principle H — an investor:

(i) applies IFRS 3 and IFRS 10 if it obtains control of an associate or joint venture;

(ii) applies IFRS 9 if it no longer has significant influence or joint control but retains an interest in a former associate or joint venture; and

(iii) recognises a gain or loss and reclassifies amounts recognised in other comprehensive income on the date that significant influence or joint control is lost.

The above list should not be considered complete but it's rather a list of principles related to the scope of the Project. For example, some principles related to the presentation have also been identified. The principles, mentioned above, are intended to be used by the IASB as a toolbox to develop new requirements rather than to be incorporated in IAS 28.

Appendix 2. List of application issues/questions for the IASB discussion

The following is the list of application questions within the scope of the project to be considered by the IASB in the future.

Changes in an investor's interest while retaining significant influence

1 How does an investor apply the equity method when disposing of an interest in an associate while retaining significant influence?

2 Whether an investor recognises its share of other changes in an associate's net assets, and if so, how is the change presented?

Recognition of losses

3 Whether an investor that has reduced its interest in an investee to nil is required to 'catch up' unrecognised losses if it purchases an additional interest in the investee?

4 Whether an investor that has reduced its interest in an investee to nil continues eliminating its share of gains arising from a downstream transaction?

5 Whether an investor that has reduced its interest in an investee to nil recognises each component of comprehensive income separately?

6 For example, in a financial year, an investee recognises a loss in comprehensive income that includes, a profit in its statement of profit and loss, and a loss in its statement of other comprehensive income

Transactions between investor and associate

7 Whether to recognise the portion of the investor's share of gain that exceeds the carrying amount of its investment in the investee in a downstream transaction?

8 Whether the investor's share of gain or loss is eliminated from the carrying amount of the investment in the investee or the acquired asset in an upstream transaction?

9 Whether the provision of service and transactions that are not transfer of assets are upstream or downstream transaction?

10 How should an investor account for gains and losses that arise from the sale of a subsidiary to an investee given the requirements of IFRS 10 Consolidated Financial Statement and IAS 28?

11 In a transaction where an investor sells a subsidiary to its investee, paragraph 25 of IFRS 10 requires the investor to recognise in full the gain or loss from the sale of a subsidiary, remeasuring any retained interest whereas paragraph 28 of IAS 28 requires an investor to eliminate the gain or loss to the extent of the retained interest in the former subsidiary.

Transactions between two associates

12 Whether the requirement for adjustment of gains and losses in intra-group transactions between subsidiaries should be applied by analogy to transactions between investees that are accounted for applying the equity method?

Impairment

13 Whether the decline in fair value is assessed in relation to the original purchase price or the carrying amount at the reporting date?

Initial recognition

14 Whether the investor recognises deferred tax assets and liabilities on the differences between the fair value and the tax base of its share of the investee's net assets?

Contingent consideration

15 How to initially and subsequently account for contingent consideration in the acquisition of an investee applying IAS 28?