STAFF PAPER

May 2016

IASB Meeting

project	The Equity Method of Accounting		
Paper topic	*Next Steps for the Equity Method of Accounting project*		
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Purpose of the paper

1. The purpose of this paper is for the International Accounting Standards Board (Board) to discuss the next steps for the Equity Method of Accounting project (Equity Method project), taking into consideration:
   - (a) progress on the limited-scope research project;
   - (b) feedback on the 2015 Agenda Consultation (Agenda Consultation); and
   - (c) feedback on the investor survey on the Agenda Consultation.

Contents of this paper

2. This paper is structured as follows:
   - (a) summary of the staff's recommendations (paragraph 3);
   - (b) progress on the limited-scope research project (paragraphs 4–16);
   - (c) feedback on the Agenda Consultation (paragraphs17–33);
   - (d) feedback on the investor survey on the Agenda Consultation (paragraphs 34–38);
   - (e) staff analysis on the feedback received (paragraphs 39–44);

(f) alternative approaches to the project (paragraphs 45–58);

(g) conclusions and recommendations (paragraph 59); and

(h) Appendix A—demographic information relating to the feedback on the Agenda Consultation.

Summary of the staff's recommendations

3. The staff recommends that:

(a) the Board defers further work on the Equity Method research project until the Post-implementation Reviews (PIR) of IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements* and IFRS 12 *Disclosure of Interests in Other Entities* are undertaken;

(b) the PIR of IFRS 10, IFRS 11 and IFRS 12 specifically seek feedback on investors' information needs regarding investments accounted for using the equity method; and

(c) the Board reconsider the scope of the project after considering the feedback on the PIR of IFRS 10, IFRS 11 and IFRS 12.

Progress on the limited-scope research project

Background to the limited-scope research project

4. At its meeting in June 2015 the Board decided to:

(a) undertake a limited-scope research project to address application problems arising from equity-method requirements in IAS 28 *Investments in Associates and Joint Ventures*;

(b) adopt a methodology for the limited-scope research project with the following assumptions:

(i) control is the appropriate basis for defining the reporting group;

(ii) associate and joint-venture entities are not part of the group and, therefore, their assets and liabilities should not be recognised separately in the financial statements; and

(iii) the unit of account is the investment as a whole.

(c) assess separately the equity method as applied to subsidiaries in separate financial statements; and

(d) consider the need for a wider scope research project on the equity method after the completion of the PIR of IFRS 10, IFRS 11 and IFRS 12.

5. The Board intended, as a first step to address application problems in the short term (including those problems that the IFRS Interpretation Committee was endeavouring to address on a case-by-case basis[1]). As a second step, the Board would consider whether there is a need for a wider scope research project on the equity method following the PIRs of IFRS 10, IFRS 11 and IFRS 12.[2]

Developments in the limited-scope research project

6. Once the Board decided to undertake a limited-scope research project, the staff sought the views of ASAF on the preliminary proposals to amend the equity method.[3] Specifically, the staff sought the ASAF's views on whether the Board consults on eliminating the requirements in IAS 28 for an entity to account for:

(a) the difference between (i) the cost of the investment and (ii) the entity's share of the net fair values of the investee's identifiable assets and liabilities as either goodwill (where (i) exceeds (ii)) or income (where (ii) exceeds (i)).

(b) that gains or losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associates or joint ventures should be recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or the joint venture. In other words, the entity's share of those

[1] Board meeting, May 2014, Agenda Paper 13.

[2] Board meeting June 2015, Agenda Paper 13.

[3] ASAF meeting October 2015, Agenda Paper 6B .

gains or losses resulting from 'upstream' and 'downstream' transactions should be eliminated.

7. In general, ASAF members did not support staff's preliminary proposals, because the proposals:

   (a) differ from the traditional view that the equity method is a one-line consolidation method. The application of the equity method as a one-line consolidation concept over the past 30 years, means the equity method should not be revised radically;

   (b) differ from the original objective of the project, which was to address application problems relating to IAS 28; and

   (c) could have a significant impact on financial performance.

8. The ASAF also said that because the project is veering away from one-line consolidation, more consideration should be given to jointly controlled entities and that simplification itself should not be the objective of this project.

9. In view of the lack of support for the staff's preliminary proposals, the staff decided that work on the project should be deferred and the approach to the project should be reconsidered in the light of the feedback on the Agenda Consultation.

10. At the December 2015 ASAF meeting the European Financial Reporting Advisory Group (EFRAG) presented its own proposal for the scope of the Equity Method project and sought ASAF views.[4]

11. EFRAG proposed that the Board work with the specific purpose of providing a basis for, and resolving difficulties in, the application of the equity method, rather than embarking on a long-term project aimed at eliminating the application of the equity method. EFRAG also said the Board:

> … should consider introducing the notion of strong interrelationships between the economic activities of the reporting entity and those entities where the reporting entity holds an equity interest that is insufficient to lead to control.

[4] ASAF meeting December 2015, Agenda Paper 9.

12. ASAF members' views on EFRAG's proposal varied. Several ASAF members supported the proposal, but some members raised concerns that:

    (a) the notion of 'strong interrelationship' might be confused with the definition of 'significant influence' and it was not clear whether 'strong interrelationship' would capture more or fewer investments than are currently accounted for by applying the equity method; and

    (b) the notion that 'strong interrelationship' can be applied to both joint ventures and associate entities needs to be evaluated.

13. Several ASAF members said that, in their view, the Board needs to verify what decision-useful information the equity method provides to users of financial statements, rather than assuming that the equity method is providing useful information in its current form, before proceeding with the project.

Other considerations relevant to the limited-scope research project

14. In June 2015 the US Financial Accounting Standards Board (FASB) issued a Proposed Accounting Standards Update Investments—Equity Method and Joint Ventures (Topic 323), which set out proposals for simplifying the equity method. The FASB proposed removing the requirements that an entity should:

    (a) account for the difference between the cost of an investment and the amount of the underlying equity in net assets of an investee (basis difference) and related disclosures[5]; and

    (b) apply the equity method retrospectively if the entity has increased its level of ownership in an investee to the point where it must adopt the equity method.

15. At the October 2015 ASAF meeting, the member from FASB provided an update on the feedback it had received for these proposals.[6] The FASB staff noted that, although the majority of United States stakeholders agreed that one-line consolidation is not a conceptual basis for the equity method, they nevertheless want to retain the

[5] This proposal is similar to the IASB staff's preliminary proposal (paragraph 6).

[6] ASAF meeting October 2015, Agenda Paper 6A.

accounting for the basis difference. After discussions, the FASB has decided to consider possible alternatives for accounting for associates' entities.

16. The feedback the FASB received on its proposals provides further evidence supporting the staff's decision to defer work on the Equity Method project and reconsider the approach to the project in the light of feedback on the Agenda Consultation.

Feedback on the Agenda Consultation

General summary

17. In response to the Agenda Consultation, the Board received 119 comment letters. In total 67 respondents commented on the Equity Method project. Respondents commented as follows:

    (a) 59 rated both importance and urgency;

    (b) a further 3 respondents rated importance only;

    (c) a further 1 respondent rated urgency only; and

    (d) 4 did not rate importance or urgency but included comments on the project.

18. The majority of responses are from Europe (43 per cent) and the Asia-Oceania region (30 per cent).[7] Of these respondents over half of the respondents are standard-setters (36 per cent) and accountancy bodies (18 per cent).[8]

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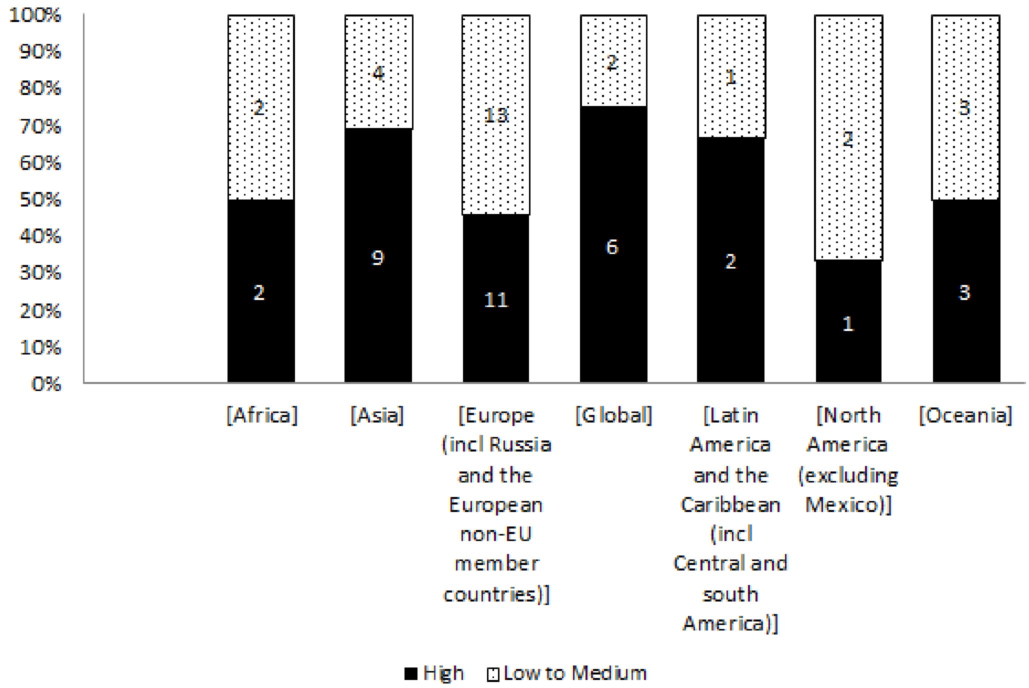
[7] See Chart 1 set out in Appendix A.

[8] See Chart 2 set out in Appendix A.

Respondents' views on the importance of the project

19. Overall, just more than 50 per cent of respondents gave the project high-importance ratings. Respondent's ratings vary according to region. Notably, more Asian respondents gave high importance ratings than did European respondents[9]. Chart 1 illustrates respondents' ratings by region.

Chart 1: Geographical distribution: importance of the project[10]



20. The staff investigated possible reasons for why ratings vary according to region. A simple database search was made to find out whether there is a concentration of equity-type investments (that is investments in which entity holds between 20 and 50 per cent) among publicly traded companies geographically[11].

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[9] 69 per cent out of the respondents from the Asian region rated the project as being of high importance, whereas only 44 per cent of the respondents from the Europe and North America did so.

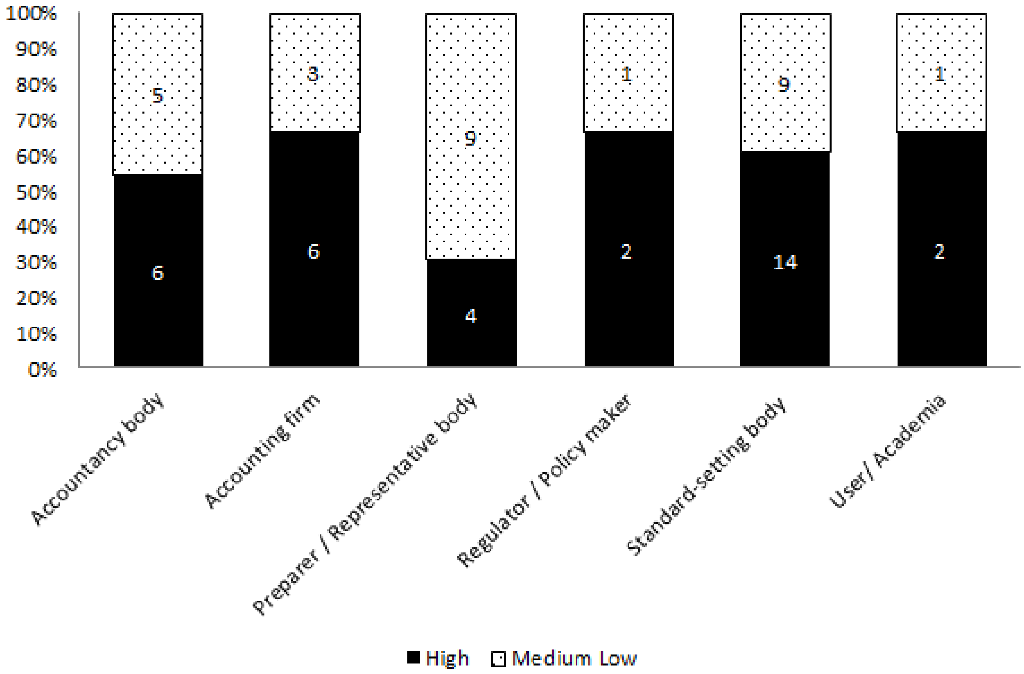
[10] One respondent did not identify the geographical region.

[11] The staff screened S&P's Capital IQ database for any publicly listed company in which another publicly listed company owns at least a 20 per cent, but no more than a 50 per cent stake. This data revealed that Asia-Oceania, Latin America and Africa had approximately twice the amount of such business relationships as did North America and Europe.

21. The staff found that the number of equity-type investments is significantly higher in Asia-Oceania, Latin America and Africa than in North America and Europe, which may help account for geographical differences in importance ratings. Changes to the equity method of accounting could have a more significant impact on the financial information reported in Asia-Oceania, Latin America, and Africa than in other regions.

22. Except for preparers, all kinds of respondents rated the project as of high importance. Chart 2 illustrates importance ratings by kind of respondent.

Chart 2: Category of respondent: importance



23. The respondents who gave the Equity Method project high importance ratings provided the following reasons:

(a) IFRS 11 has increased the number of entities that are accounted for using the equity method;

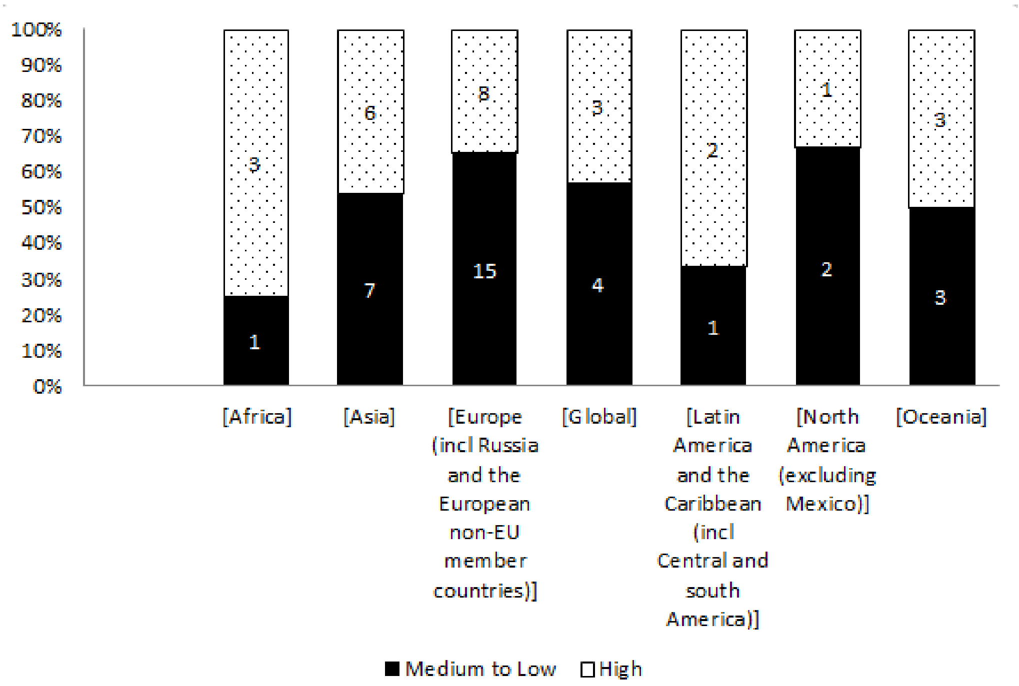
(b) permitting the use of the equity method of accounting for subsidiaries in separate financial statements has also increased the use of the equity method; and

(c) various amendments to Standards in recent years have clouded the operability and conceptual basis of the equity method.

Respondents' views on the urgency of the project

24. Overall, respondents gave the project low to medium urgency ratings, with differences among regions. Respondents from Asia gave the project higher urgency ratings than did respondents from Europe. Chart 3 illustrates urgency ratings by region.

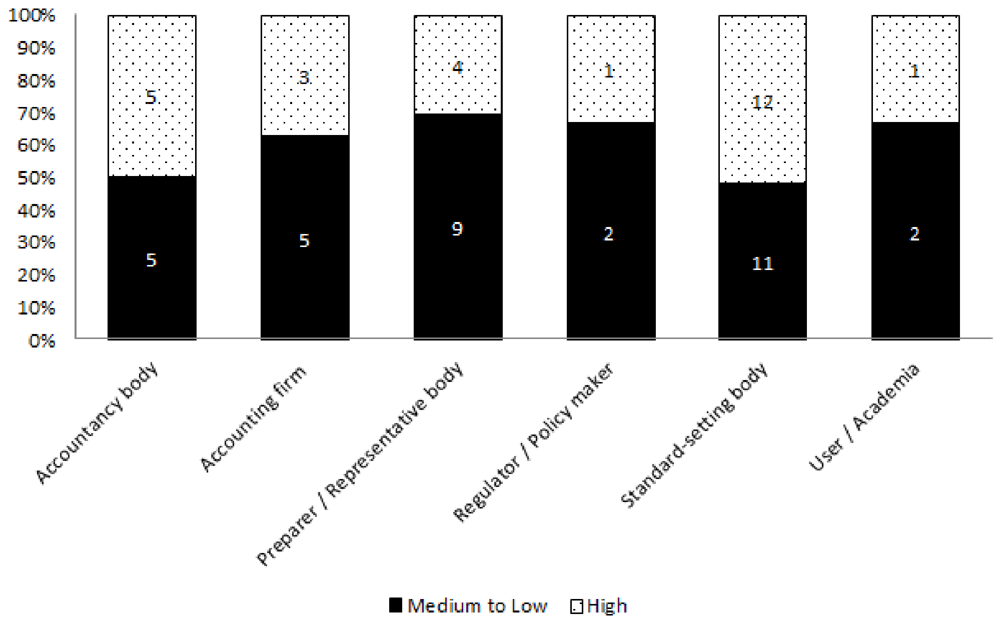
Chart 3 Geography of respondent: urgency of the project[12]



[12] One respondent did not identify the geographical region.

25. There are few differences in the urgency ratings among different kinds of respondents. Chart 4 illustrates urgency ratings by kind of respondent.

Chart 4: Category of respondent: urgency of the project



26. Respondents emphasised the importance of the Equity Method project more than its urgency.

Respondents' views on how to proceed with the project

27. Respondents who expressed opinions on how to proceed with the Equity Method project had different views on the project's scope; some respondents say the Board should do a fundamental review of the equity method of accounting rather than a limited-scope research project addressing current application problems.

28. In particular, the accounting firms suggested that the Board provide clarity on the equity method. For example, one accounting firm said:

> Equity accounting is becoming more widely used with IFRS 11 no longer allowing for proportionate consolidation. In addition, various IASB amendments in recent years have made the operability and conceptual basis of equity accounting even less

> clear. Some amendments are now to be deferred pending a research project. Therefore getting clarity on the equity method is important. (KPMG, CL51).

29. Respondents' preferred approach to the project varied by geographical region. Most European respondents suggested the project balance focusing on fundamental principles with addressing application problems. According to these respondents, the Board needs to address the application problems in practice rather than starting a time-consuming and resource-intensive fundamental review. These views are reflected in the following comment letter extracts:

> The validity and utility of this method of accounting for certain investments appear to be well established and need not be re-examined. However, there is a number of issues which have been identified and warrant resolution on a consistent basis across standards. (BusinessEurope, CL43)

> …We do not think it is necessary to spend time developing a conceptual justification for equity accounting, as the utility of this method is not contested today. (ACTEO-AFEP-MEDEF, CL31)

30. In contrast, most Asian respondents suggested that the project focus on fundamental principles, including the nature of equity method accounting and its information value as well as when its application is most appropriate. These respondents also say it is difficult to address application problems without a fundamental review of the equity method of accounting itself. This view is reflected in the following comment letter extracts:

> … Narrow-scope amendments cannot be an effective quick-fix for underlying fundamental issues in a Standard. The identification of many application issues on a Standard could be indicative that the IASB might need to reconsider the underlying principles, rather than to attempt fixing the different issues on a piecemeal basis. A case in point is the equity method under IAS 28, wherein the IASB has decided that a research project would be necessary to address the various application issues, after resources have been expended to

> discuss a number of narrow-scope amendments, to issue some of those amendments, and even to expand the use of the equity method. (Singapore Accounting Standards Council, CL39)
>
> Until the IASB has articulated the need for or the objective of the equity method, we are concerned that any amendments to the method might further complicate the accounting without any comparable benefit or conceptual basis. (Hong Kong Institute of Certified Public Accountants, CL78)

31. Other views on how the Board might proceed with the project included:

    (a) the current IAS 28 is relatively old and needs to be updated to reflect current thinking.

    (b) a PIR could lead to identifying new application problems. The findings from a PIR could provide the basis for a more fundamental review of the equity method of accounting. These respondents also said that such a fundamental review would result in a single lasting solution, which they would prefer to a number of smaller amendments that would lead to a sequence of accounting process changes.

    (c) the equity method of accounting has fundamental inconsistencies, as evidenced by the number of queries to the IFRS Interpretations Committee.

32. It is important to note that a 'fundamental review' had a varied meaning among respondents. A few respondents, including EFRAG, suggested that a fundamental review should only examine the process of applying the equity method set out in IAS 28 and its known problems, such as the definition of significant influence. In contrast, other respondents said a fundamental review should extend beyond the application of equity method and its known problems and include when the equity method should be applied.

33. From the responses to the Agenda Consultation we have identified the following possible topics for inclusion in a fundamental review:

    (a) the conceptual basis for the equity method of accounting, including:

(i) whether the equity method is a one-line consolidation or a measurement method;

(ii) what 'significant influence' means and why it affects the nature of the information that users of financial statements need; and

(iii) what the relationship is between the equity method and the concept of 'control'.

(b) how the equity method of accounting should be applied (methodology), including how the equity method can reflect information about different ownership-interest structures and changes in these structures, for example, step acquisitions.[13]

(c) how useful the information provided by the equity method of accounting is for users, and whether it is equally useful in all situations where the equity method is used. For example, does the equity method provide decision-useful information where an entity has joint control, as opposed to when an entity has significant influence?[14]

(d) whether other methods—such as proportionate consolidation, cost or fair value—provide more decision-useful information in some or all of the cases when the equity method is currently used.

Feedback on the investor survey on the Agenda Consultation

34. The Board received 169 responses to the investor survey on the Agenda Consultation. Seventy investors responded to the question on the equity method of accounting.

35. A majority of investor respondents agreed that the equity method project is important, but not urgent. Most of these respondents said it would be helpful to introduce clearer disclosures in the investors' financial statements about the investee's net assets.[15]

[13] IFRS Interpretations Committee (CL18)

[14] Singapore Accounting Standards Council (CL39)

[15] The respondents did not mention specifically the form or nature of these 'clearer disclosures'.

36. A number of respondents stated that the figures presented in the investors' financial statements using the equity method, although not perfect, provide them with a starting point for understanding the value of the holding. The following comments from the investor survey responses reflect these views:

> It works well, but is not perfect. It is an indication of fair values in the shares.
>
> We need to see this both ways. Consolidated and with the equity method. Neither method alone does the best job but the equity method is probably more correct in most cases. It presents what actually is legally the case.

37. A few respondents stated that the equity method of accounting should be abolished; perhaps to be replaced with the proportional consolidation method of accounting.

38. Because of the limited number of detailed responses from investors it is not possible to propose a direction for the project based on investor feedback. However, it is evident that investors have diverse views on the equity method of accounting.

Staff analysis on the feedback received

39. Feedback on the Agenda Consultation, the investors' survey and the staff's preliminary proposals presented to ASAF identify no clear path forward for the Equity Method project because:

    (a) there are mixed views on the scope of the project;

    (b) investors have diverse views on the equity method of accounting; and

    (c) proposals to simplify the equity method lack support.

40. Conceptually, whether the equity method of accounting is a one-line consolidation method or a measurement basis is widely debated. Current requirements in IAS 28 appear to embody both the consolidation and measurement characteristics. The existing dual-nature characteristics appear to have ensured that the equity method, as set out in IAS 28, remained relevant for investors' economic decision-making, even

though concerns about conceptual inconsistencies and practical application problems have arisen over the years.[16]

41. Because of the dual-nature characteristic, the staff's preliminary proposals to remove the elimination entries and the accounting for 'basis difference' implied a move away from the 'one-line consolidation' and hence a move towards a measurement basis.

42. In view of the feedback on the staff preliminary proposals (paragraph 7) we are conscious that any attempt to simplify the equity method will inevitably raise questions about the conceptual basis for the equity method.

43. We also think that the Agenda Consultation has identified questions about the range of the economic relationships that the equity method is applied to—that is, investments that range from 'significant influence' to 'controlled entities'.

44. The staff therefore concur with the feedback from respondents that to solve the current application problems consistently, the Board needs to provide clarity, or a conceptual basis for the equity method of accounting.

Alternative approaches to the project

45. The staff have identified four possible alternatives for the Board to discuss the next steps on the future of the Equity Method project.

Alternative 1—continue the limited-scope research project

46. At its June 2015 meeting, the Board decided to undertake a limited-scope research project to address application problems arising from the equity-method requirements in IAS 28. The objective was to reduce the need for continual narrow-scope amendments to IAS 28 before the Board decided on the need for a wider scope research project on the equity method of accounting.

[16] These concerns had always surfaced whenever a set of proposals were being deliberated or when substantial changes in the scope of Standards were being deliberated (for eg: elimination of proportionate consolidation in IFRS 11). The main concern from the respondent's point of view was that a proper reassessment of the conceptual basis of equity method of accounting was not conducted at each of these deliberations. One of the best examples is described in paragraphs 14 to 19 in Agenda Paper 13 of the June 2015 Board meeting.

47. The Board need not expedite the project by undertaking a limited-scope research project to address application problems, since most respondents said the project was important but not urgent[17].

48. The staff acknowledge that a significant number of respondents, 43 per cent, rated the project as urgent. However, given the lack of support for the staff's preliminary proposals, finding solutions to the application problems acceptable to constituents will not be easy without addressing the conceptual principles of the equity method.

49. Although continuing with a limited-scope research project remains an alternative for the Board to consider, feedback on the Agenda Consultation and the lack of support for the staff's preliminary views have caused the staff to reconsider the merits of continuing a limited-scope research project.

Alternative 2—perform limited-scope outreach with investors

50. The staff have considered the merit of conducting outreach with investors to improve our understanding of investors' information needs. Improving our understanding of investors' information needs might help us understand why the staff's preliminary proposals were not supported. A better understanding of investors' information needs might also help identify alternative short-term solutions to the current application problems with the equity method.

51. Using the findings from the outreach with investors the Board could reconsider whether to proceed with the limited-scope research project or it could revise the scope of the project. However this approach retains the same disadvantages of Alternative 1 while taking a longer time to arrive at possible solutions.

Alternative 3—conduct a fundamental review of the equity method

52. The Board could conduct a fundamental review of the equity method of accounting to address topics identified in paragraph 33.

53. The staff believe that this alternative would start by finding out the information needs of investors. Depending on those information needs, the project could review when the equity method should be applied and whether other methods would better suit

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[17] It is worth noting that the 2011 Agenda Consultation identified a strong call for the Board to examine the equity method.

investors' information needs. Following this, the project could review possible changes to the current requirements of IAS 28.

54. The merit of this alternative is that it should lead to a strong conceptual basis that would in turn lead to a more comprehensive solution to the issues identified thus far in the project.

55. A number of Agenda Consultation respondents discussed the merits of proceeding with the project as a part of a relevant PIR. The Board is likely to commence the PIR of IFRS 10, IFRS 11 and IFRS 12 this year. Given that the PIR are imminent, the staff question whether now is an appropriate time for the Board to commit to a full research project when a PIR will be undertaken on a closely related topic in the near future.

56. Consequently, the staff do not support commencing a research project at this time. It is important to note that if the PIRs for IFRS 10, IFRS 11 and IFRS 12 were not taking place the staff would recommend this alternative.

Alternative 4 – gather information as part of the PIR of IFRS 10, IFRS 11 and IFRS 12

57. The staff suggest that the best course of action for the project, given all the feedback, is to wait for the PIR of IFRS 10, IFRS 11 and IFRS 12 to be undertaken. The PIR could specifically seek views from investors on their information needs for investments accounted for using the equity method. In addition, the PIR may identify application problems that have not yet been identified.

58. We think that the Board could reconsider the scope of the project based on the feedback received on the PIR. We do not believe the Board needs wait until the PIR is completed to determine the scope of a new project.

Conclusions and recommendations

59. On the basis of the discussion outlined in paragraphs 45–58 the staff recommends that:

    (a) the Board defers further work on the Equity Method research project until the PIR of IFRS 10, IFRS 11 and IFRS 12 are undertaken;

(b) the PIR of IFRS 10, IFRS 11 and IFRS 12 specifically seek feedback on investors' information needs regarding investments accounted for using the equity method; and

(c) the Board reconsider the scope of the project after considering the feedback on the PIR of IFRS 10, IFRS 11 and IFRS 12.

Question for the Board
Does the Board agree with the staff's recommendation?

Appendix A—Demographic information relating to the feedback on the 2015 Agenda Consultation

Chart 1: Comment letters by geographical region

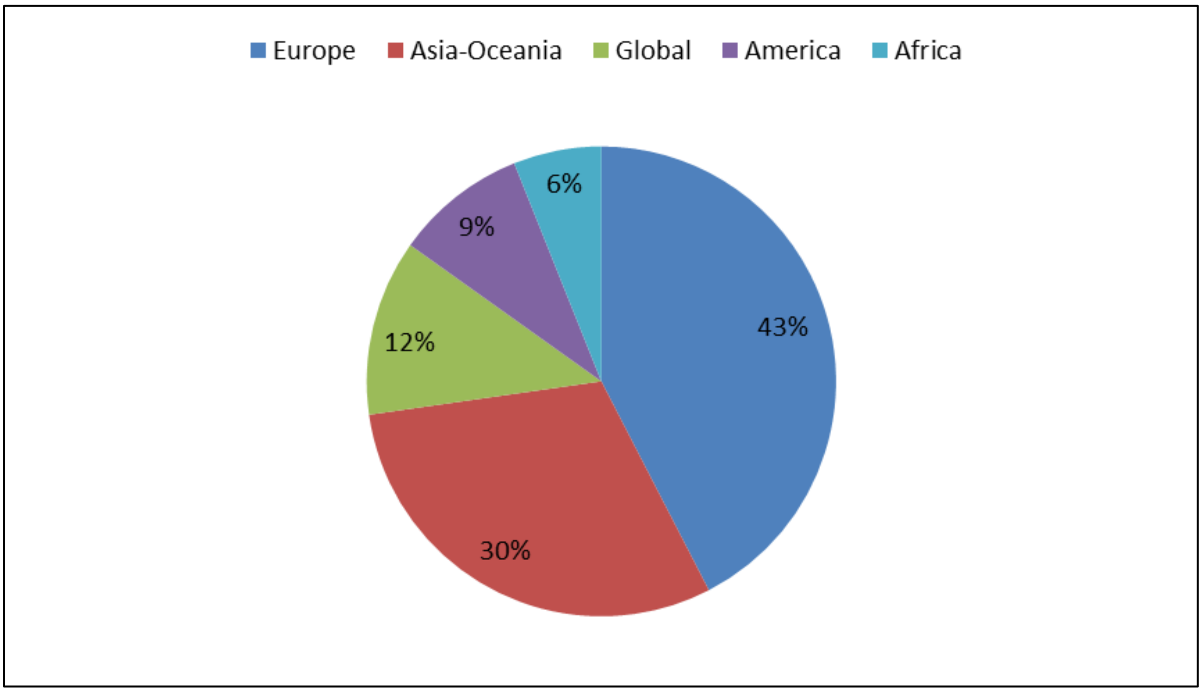

Chart 2: Comment letters by type of respondent