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Perspectives on the Equity Method of Accounting

Megumi Makino
Project Manager
Accounting Standards Board of Japan

The views expressed in this presentation are those of the presenter, not necessarily those of the Accounting Standards Board of Japan.

Executive Summary of the Paper

- We propose principles that would clarify when to focus on the aspect of one-line consolidation and a measurement basis to address the current practical issues
  - IAS 28 is consistent with neither one-line consolidation in its purest form nor a measurement basis in its purest form – IAS 28 adopts a hybrid approach
- Our view is that the equity method of accounting should be consistent with one line-consolidation subject to a few exceptions
  - The exceptions arise from the fact that significant influence or joint control is not obtained by accident (that is, management makes deliberate decisions to obtain significant influence or joint control, taking into account the accounting that will follow)
  - While significant influence or joint control does not constitute control, associates and joint ventures accounted for using the equity method of accounting are closer to the investor compared to investments accounted for in accordance with IFRS 9 and thus warrant accounting that is closer to consolidation
- Some of the existing requirements in IAS 28 would need to be amended to incorporate the principles we propose

What is NOT Addressed in the Paper

- **This paper does not discuss the appropriateness of the scope of entities to the equity method of accounting should apply**
  - This paper takes the scope of entities that are to apply the equity method of accounting as currently required in IFRS Standards
- **This paper ignores the requirements in IAS 28 related to a venture capital or a similar organization**

Part A – The Three Main Approaches (1)

One-Line Consolidation

- One-line consolidation should have the exact same effect on total net assets and profit or loss as if the equity method investee were consolidated
- However the current requirements under IAS 28 are inconsistent with this view in its purest form

A Measurement Basis

- The equity method as a measurement basis would account for the net investment as a single asset
- However the current requirements under IAS 28 are inconsistent with this view in its purest form
  - In its purest form, the elimination of unrealised profits or losses from upstream and downstream transactions would not be required

A Hybrid of the Two Approaches

- IAS 28 adopts a hybrid of the two approaches and we support this approach

Part A – The Three Main Approaches (2)

- **We believe that the equity method of accounting is based on one-line consolidation, with a few exceptions**
  - Neither significant influence nor joint control constitutes control
    - Accordingly, requiring the equity method of accounting to have the same effect as if the investor controlled the investee may not result in a faithful representation of the investment
  - Management makes deliberate decisions to obtain significant influence or joint control
    - Equity method investees are closer to the investor compared to investments accounted for in accordance with IFRS 9, and thus warrant accounting that is closer to consolidations
- **When adopting a hybrid approach, it is necessary to clarify when to place more emphasis on one approach over the other and why**
  - We propose principles that could be applied to the hybrid approach

Part B – Our Proposed Principles – Principle 1

Principle

- **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.**

Rationale

- Neither significant influence nor joint control constitutes control of an investee and it would be inappropriate to recognise the full amount of the individual assets and liabilities.
- It is questionable whether proportionate consolidation is appropriate; it is clear that the investor controls an interest in the associate or joint venture.

Implications

- The interest in the associate or joint venture would be recognised as a single asset.
- The income or expense from the investment represents the investor's share of the net profit or loss of the associate or joint venture.
- Gains or losses that would be eliminated from upstream and downstream transactions would be the investor's share of such gains or losses.

Part B – Our Proposed Principles – Principle 2

Principle

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.

Rationale

- Interest in the associate or joint venture will be accounted for as a single asset.
- A liability should be recognised:
  (a) to fully eliminate the gains from downstream transactions (if a liability is not recognised, profit or loss will be reduced in the subsequent period(s)); and
  (b) to be consistent with the notion that dividends are returns ***of*** investments, not returns ***on*** investments.

Implications

- Impairment would be tested against the interest in the associate or joint venture in its entirety.
- A liability should be recognised when, and only when:
  (a) the investor has legal or constructive obligations to absorb the losses; or
  (b) the amounts that would otherwise be eliminated exceed the carrying amount of the investment.

Part B – Our Proposed Principles – Principle 3

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Principle

Neither significant influence nor joint control constitutes control of an investee. Accordingly, the accounting requirements related to consolidation 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.

Rationale

- The accounting requirements in IFRS 10 and IFRS 3 are based on the notion that obtaining control of another entity is a significant economic event.
- Obtaining significant influence or joint control should not be viewed to be the same as obtaining control of an investee. The accounting required under consolidations for the investor's ownership interests based on the concept of a group should not be carried over to the equity method.

Implications

- When significant influence or joint control is obtained in steps, the investments previously made may not be measured at fair value at the date significant influence or joint control is obtained.
- When the investor's interest in the associate or joint venture changes w/out losing significant influence or joint control, the transaction would not be viewed as a transaction with owners.
- The holdings in an investment by associates and joint ventures would not be counted as a group's share. Also, associates and joint ventures' holding of the investor's shares is not accounted for as treasury shares.

Part B – Our Proposed Principles – Principle 4

Principle	**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.**
Rationale	▶ Significant influence or joint control is not obtained by accident but only as a result of deliberate decisions by management, which warrants accounting that is closer to consolidation. ▶ Significant influence or joint control indicates the investor's involvement in the management of the associate or joint venture. The performance of the investment should not merely be determined by the change in the fair value of the investment. ▶ Accounting requirements related to the equity method generally should be consistent with the accounting requirements related to consolidation.
Implications	Share of profit or loss and OCI of the associate or joint venture would be recognised in the investor's profit or loss and OCI, respectively. Measurement of identifiable net assets of the associate or joint venture and contingent consideration would follow the requirements in IFRS 3. Unrealised gains and losses from upstream and downstream transactions would be eliminated. Receivables/payables and income/expenses that do not involve the transfer of assets between the investor and the associate or joint venture would be eliminated.

Part C – Accounting for Consolidations

In Parts A and B, we take the requirements related to the accounting for consolidations as granted. However, in Part C, we present our views on the current requirements related to the accounting for consolidations.

- **In the case of step acquisitions, we are of the view that investments previously made should not be remeasured when the investor obtains control.**
  - The requirements in IFRS 10 and IFRS 3 are based on the notion that obtaining control of another entity is a significant economic event that warrants a change in accounting such that the investments previously made would be remeasured at fair value at the acquisition date.
  - The required accounting would have the same effect as if the entity sells the investments previously made at fair value at the acquisition date.
    - The investments previously made have not been sold and it would be difficult to say that the faithful representation of an additional purchase of shares would involve the accounting for the sales of the previously held shares.

Questions for Meeting Participants

- Do you agree that the equity method of accounting should adopt a hybrid approach?

- Do you have any comments on our proposed principles?