Accounting Standards Board of Japan (ASBJ)
Fukoku Seimei Building 20F, 2-2, Uchisaiwaicho 2-chome, Chiyoda-ku, Tokyo 100-0011, Japan
Phone +81-3-5510-2737 Facsimile +81-3-5510-2717 URL http://www.asb.or.jp/

17 June 2014

European Financial Reporting Advisory Group
25 Square de Meeûs
B-1000 Brussels
Belgium

Comment on Short Discussion Series *The equity method: a measurement basis or one-line consolidation?*

The Accounting Standards Board of Japan (ASBJ) welcomes the opportunity to provide comments on European Financial Reporting Advisory Group (EFRAG)'s Short Discussion Series *The equity method: a measurement basis or one-line consolidation?*

1. The ASBJ supports EFRAG's initiative to explore the underlying nature of the equity method of accounting, as it acknowledges that there are various conceptual and application issues in relation to the application of the equity method of accounting.
2. The equity method of accounting has been referred to as the 'one-line consolidation', because many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures. If the nature of the equity method of accounting is viewed as a 'one-line consolidation', we are likely to conclude that profit or loss, other comprehensive income (OCI) and change in net assets recognised through the application of the equity method *should* result in the same outcome as those recognised using the consolidation procedures.
3. However, recently published standards (including IFRS 3 *Business Combinations* and IFRS 10 *Consolidated Financial Statements*) place considerable weight on the concept of 'control', and the term 'group' is defined as a parent and its subsidiaries. This group concept naturally gives rise to a 'cliff-effect' between accounting outcomes of an investment in a subsidiary and those of an investment in other entities (including associates). Therefore, some may argue that it is difficult to find a conceptual ground that supports the notion of a 'one-line consolidation'.
4. The ASBJ thinks that the usefulness of the information provided through the use of the equity method of accounting has a lot to do with the scope of its application. Nevertheless, the ASBJ believes that it is at the least inappropriate to make

fundamental changes to the existing requirements relating to investments in associates or joint ventures, such as through replacing the equity method of accounting with the requirements to measure them at FV-PL to be in line with the accounting requirements for equity instruments as stipulated in IFRS 9 *Financial Instruments*.

5. In order to form an informed view, the ASBJ recently carried out a survey designed to seek feedback from financial statement users (‘users’), financial statement preparers (‘preparers’) and auditors in Japan. The ASBJ found that almost all stakeholders stated that the equity method of accounting provides useful information for users, as it reflects the financial performance of investees in the group’s financial statements in a timely manner. They also stated that a group’s financial statements will fail to provide useful information to users, if they were to measure all equity investments at FV-PL or they were to recognise profit or loss from investments in associates or joint ventures solely on the basis of dividend incomes from their investees. At the same time, preparers identified a number of practical challenges in the application of the equity method of accounting. For example, they stated that it is often challenging to obtain sufficient information necessary to apply the equity method of accounting within a short period of time. For details of the feedback, please refer to Appendix of this letter.

6. Having considered the feedback from respondents, the ASBJ thinks that it would be helpful if the IASB’s planned research could help clarify the following:

   (a) Within the context of discussions relating to profit or loss under the *Conceptual Framework*, how we can rationalise the nature of ‘profit or loss’ recognised through the use of the equity method of accounting, and in what situations the equity method of accounting should be required (that is, an appropriate scope for the equity method of accounting).

   (b) In what cases would procedures similar to those employed for consolidation be *necessary* in the application of the equity method of accounting; and in what cases would procedures similar to those employed in consolidation be considered to be *desirable*.

   (c) How we can alleviate the practical burden relating to the application of the equity method of accounting, while maintaining the usefulness of the resulting information.

Appendix

<u>Summary of feedback received for the ASBJ's survey</u>

1. As a result of the survey explained in paragraph 5 of this letter, the ASBJ received feedback from a number of respondents (users, preparers and auditors) on the following matters:

   (a) Usefulness of the financial information resulted from the application of the equity method;

   (b) Scope of the equity method of accounting; and

   (c) Implementation challenges resulted from the equity method of accounting.

<u>Usefulness of the financial information resulted from the application of the equity method</u>

2. Presuming that the 'group' concept under the existing IFRSs continues to be appropriate, the ASBJ sought views as to whether information resulted from the application of the equity method (especially investor's profit or loss based on its share of the investee's profit or loss) provides useful information.

3. In response to this question, some preparers stated that the equity method of accounting does not provide useful information for users of financial information, primarily because the nature of investments in associates is diverse significantly and it is difficult to identify an appropriate scope for investments that should be accounted for using the equity method of accounting.

4. However, almost all respondents (all users and almost all preparers) stated that the equity method of accounting generally provides useful information (especially investor's profit or loss based on its share of the investee's profit or loss) for users. Feedback received included the following:

   - Measuring all equity instruments including investments in associates at FV-PL would fail to provide useful information to users, especially when investments in associates are not held for the purpose of capital appreciation through sale, or when reliable measurement is found to be difficult for equity investments in unlisted companies.

   - Recognising dividend income alone would not properly portray the financial performance of the investee in the group's consolidated financial statements because dividend income often comes with a time lag.

   - The equity method provides useful information for investments in associates, because such investments are often held as part of a business activity for the purpose of returns on the investees' business outcome by exercising significant influence over investees.

Scope of the equity method of accounting

5. To respondents who stated that the equity method of accounting generally provides useful information, the ASBJ questioned whether there are any instances where the equity method does not provide useful information.

6. In response to this question, all users stated that there are some cases where the equity method of accounting fails to provide useful information to users. For example, a user stated that measuring an investment at fair value would provide more useful information where an investee is a listed entity.

7. Some preparers stated that the scope of the equity method of accounting should be reconsidered, because they believed that in some cases, the equity method of accounting would fail to provide useful information to users. They referred to specific situations, for example:

   - Where a dividend policy of an associate is controlled by another entity. This might be the case where an associate is a subsidiary of another entity; and

   - Where a group intends to sell off its investment in an associate in the near-future.

8. In addition, some respondents suggested that the IASB clarify the conceptual ground why the bright-line of twenty-percent of share holdings is supposed to give rise to 'significant influence' and investments of less than twenty-percent of share-holding are presumed to be otherwise, especially when investments in the latter are held for strategic purposes.

Implementation challenges relating to the equity method of accounting

9. The ASBJ also questioned whether stakeholders faced significant implementation challenges, when applying the equity method of accounting.

10. In response to this question, a significant majority of preparers identified a number of implementation challenges, and suggested that the IASB clarify to what extent the equity method procedures should analogise consolidation procedures. Key points of the preparers' comments include the following:

    (a) Availability of sufficient information in a timely manner;

    (b) Challenges regarding unification of accounting policies and reporting periods between an investor and investees; and

(c) Challenges regarding impairment testing of investments accounted for using the equity method of accounting.

11. This paragraph provides the detail relating to the three points identified in the previous paragraph.

(a) Availability of sufficient information in a timely manner

- A significant majority of preparers stated that, depending on the power of other shareholders relative to that of the investor, they faced challenges in obtaining sufficient information necessary to apply the equity method of accounting within a short period of time.
- Obtaining sufficient information in a timely manner was particularly challenging, when investees are:
    - Listed entities;
    - Entities of which shares are held by another controlling shareholder or another large shareholder; or
    - An investee which itself constitutes a group of entities.

(b) Challenges regarding unification of accounting policies and reporting periods

- Many preparers stated that unification of reporting periods and accounting policies between an investor and its investees (as required in IAS 28 *Investments in Associates and Joint Ventures*) were often difficult, because investors do not have sufficient power to impose investees to follow the same accounting policies and reporting periods of investors.

(c) Challenges regarding impairment testing of investments accounted for using the equity method of accounting

- Some preparers found that it is sometimes challenging to carry out impairment testing for investments accounted for using the equity method of accounting. This is because IAS 28 requires many procedures similar to the consolidation procedure under which an investee is not treated as a single asset (for example, as required by paragraph 42 of IAS 28), but also requires that impairment testing of such investments be carried out by treating the investment as a single asset in accordance with IAS 36 *Impairment of Assets.*