# Accounting Standards Advisory Forum meeting

## Equity Method of Accounting

**December 2014**

# Feedback to the Survey on Equity Method of Accounting

The Accounting Standards Board of Japan

## I. <u>Overview</u>

1. The IASB initiated a research project on the equity method of accounting in response to the feedback received to the Agenda Consultation 2011. Having acknowledged the critical importance of the issue, the ASBJ carried out a survey to Japanese constituents to seek their views on the usefulness and practical challenges relating to the information using equity method of accounting. The ASBJ shared the summary of responses received to the questionnaire with EFRAG as it issued the Discussion Paper, *EFRAG Short Discussion Series - The Equity Method: a measurement basis or one-line consolidation?*

2. In designing the survey, the ASBJ focused on basic issues rather than technical details, because it believed that setting the right scope is of utmost importance at the initial phase of the research project. In addition, the ASBJ believed that focusing on basic issues would be an effective way to receive the highest rate of responses. Accordingly, the ASBJ asked the following matters in its questionnaire (a list of questions are reproduced in Appendix-I of this paper.) :

   (a) Whether information resulting from the application of the equity method of accounting is found to be useful;

   (b) Whether the scope of the equity method of accounting under the existing accounting standards is considered to be appropriate; and

   (c) What matters are found to be major implementation challenges when complying with accounting requirements relevant to the equity method of accounting.

3. The ASBJ sent a questionnaire to financial statement users, preparers and auditors, assisted by relevant organisations[1]. Even with a very short comment period (from 15 April 2014 to 12 May 2014), the ASBJ received 28 responses in total, of which the details are as follows:

   - Financial statement users: 4 individuals;
   - Financial statement preparers: 23 corporations[2]; and
   - Auditors: 1 organisation[3].

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[1] The ASBJ expresses special appreciation to the Securities Analysts Association of Japan (SAAJ), Keidanren and the Japanese Institute of Certified Public Accountants (JICPA), as they provided assistance with the survey.

[2] All responses are from listed companies, and most of them are multi-national global companies. Industries in which these corporations operate include manufacturing, financial services (banking, insurance services), shipping, chemical, railways and trading companies. These respondents include users of IFRSs, Japanese GAAP and US GAAP and all these standards provide generally consistent accounting requirements with regard to the equity method of accounting.

## II. Summary of responses

4. Responses the ASBJ has received to the survey are summarised in the following paragraphs.

*(a) Whether Information Resulting from the Application of the Equity Method is Useful*

5. The ASBJ sought views as to whether information resulting from the application of the equity method (especially an investor's profit or loss relative to its share of an investee's profit or loss) to investments in associates provides useful information.

6. In seeking feedback, the ASBJ asked respondents to presume that the 'group' concept under existing IFRSs is unchanged (that is, to presume that the group comprises a parent and its subsidiaries), because changing the group concept is more fundamental and would require a different set of questions. In addition, the ASBJ limited the question to investments in associates rather than trying to ask about the relevance of the equity method of accounting to investments in joint ventures. The ASBJ believed that the scope of applying the equity method of accounting would be much larger for investments in associates and it would be efficient to give consideration to investments in joint ventures after considering the basic questions for investments in associates.

7. Summary of responses to this question is as follows:

- All users stated that they found the information resulting from the application of the equity method of accounting to be useful.
- Most preparers (87% or 20 out of 23) stated that the information resulting from the application of the equity method of accounting is generally considered to be useful.
- Many auditors stated that the equity method of accounting is considered to be useful, while others questioned the usefulness of the information.

8. Respondents who stated that **the equity method of accounting contributes to providing useful information** shared the following comments:

*(Responses from users)*

- Measurement at FV-PL being irrelevant: Measuring all equity instruments including investments in associates at FV-PL would fail to provide useful information to users of financial statements, especially when these investments are not held for the purpose of capital appreciation through sales, or when a reliable fair value measurement is found to be difficult (this would be

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[3] This response represents the collective views of 15 senior public accountants from large audit firms, who are interested in this topic.

particularly the case for equity investments in unlisted entities.)

- Lateness of dividend income: Recognising dividend income alone would not properly reflect the financial performance of investments in associates in the group's consolidated financial statements, because dividend income often comes with a time lag.

- Consistency with an entity's business activities: The equity method of accounting is relevant for investments in associates, because they are often held as part of their business activities aiming to earn returns on the investees' business outcome, and an investor participates in business decisions of investees as a major shareholder.　Yet it may be worthwhile to consider fair value measurement for investments in associates, when associates are listed entities or when investments in associates are found to be frequently sold.

- Inapplicability of gross presentation: If assets and liabilities of associates are recognised in the group's consolidated financial statements, such information would fail to represent the group's financial condition and would be misleading. Thus, net presentation through the use of the equity method of accounting is a well-balanced way of communicating useful information.

*(Responses from preparers)*

- Responsibility of group management: The equity method of accounting provides useful information for investments in associates, because group management is usually responsible for profitability of the investees as part of the group's business management.　The focus of group management is usually to increase profitability from the investments by exercising power (in this case, significant influence) over them.　In other words, such investments are not usually held to gain cash flows through sales of investments in the market.

- Timely recognition of profits or losses: The equity method of accounting is considered to provide useful information on profits or losses in the consolidated financial statements, because it contributes to providing more *timely* information about the investments than when measuring such investments at cost.

- Challenges for reliable fair value measurement: It would be significantly challenging to reliably measure the fair value of investments in associates, and such measurement is inappropriate.　On the other hand, the equity method of accounting is evidenced by the investees' financial statements which have a higher degree of objectivity.　In addition, measurement at cost would fail to represent the existence of significant influence on the face of financial statements.

- Cost-benefit: Costs associated with the equity method of accounting is relatively smaller than the costs required for fair value measurement or proportionate consolidation.

*(Responses from auditors)*

- Prevention of earnings management: Compared with measurement at cost, the equity method of accounting provides better information, because measurement at historical cost entails risks of earnings management through managing or negotiating the timing of dividend payments.
- Responsibility of group management: The equity method of accounting provides useful information for investments in associates, because group management is considered to be responsible for the performance of associates over which it has significant influence.
- Timely recognition of profits or losses: The equity method of accounting enables the group to report the effect of changes in net assets and the performance of investees in a timely manner.
- Irrelevance of fair value measurement: Measurement at FV-PL does not reflect the economic substance of investments in associates, as they are not held to gain returns on appreciation of market prices of the investments.

9. Some constituents stated that **the equity method of accounting does not contribute to providing useful information** for users of financial information primarily for the following reasons:

*(Responses from preparers)*

- Similarity of nature to other investments: The scope of investments to which the equity method of accounting is applied is significantly broad, and the nature of investees differs significantly among them. The equity method of accounting is not considered to be useful when the nature of investments is similar to those measured at cost or FV-OCI or when there is a controlling shareholder for the investee. In addition, it would be important to note that the effect on profit or loss from the equity method of accounting is sometimes so significant that the impact of the loss from the use of equity method of accounting offsets the total profit from the group's operation.
- Function of associates under the group's strategy: Usefulness of the equity method of accounting is questionable, because associates are expected to function as part of the value-chain of the group under the group's strategy and

capital gain is not the purpose of such investments. In addition, an investor is not able to control the dividend policy of associates, and it is not certain whether such dividends will be distributed to an investor. Thus, such investments should rather be measured at FV-OCI or cost.

*(Responses from auditors)*

- Diversity of application in practice: There is diversity in practice for the application of the equity method of accounting, due to a lack of guidance in IAS 28.

*(b) Whether the scope of the equity method of accounting is appropriate*

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

11. Summary of responses to this question is as follows:

- All users stated that the there are some cases when using the equity method of accounting is not found to be useful.
- Many preparers (45% or 9 out of 20) stated that the information resulting from application of the equity method of accounting is not considered to be useful in some circumstances.
- Some auditors stated that the equity method of accounting is not considered to be useful in some circumstances.

12. Respondents who pointed out circumstances where information resulting from the equity method of accounting is not useful shared the following comments:

*(Responses from users)*

- Some investments being held solely for financial purposes: The equity method of accounting may not be relevant, when an entity holds more than twenty-percent of investees' shares solely for financial assistance rather than as part of its business investments.
- Difficulties in understanding risk exposures from investments: Risks associated with investments in associates differ depending on cases. For example, for some investments, an investor may have risk exposure beyond the nominal amount of the investment, but in other cases the risk exposures are limited to the nominal amount of investments. Such risk exposure is not necessarily clear under the existing disclosure requirements.

*(Responses from preparers)*

- Circumstances where the equity method of accounting would not be relevant: The equity method of accounting may fail to provide useful information to users in the following circumstances when:
  - 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.
  - A group intends to sell off its investment in an associate in the near future.
  - An associate is a listed entity.

*(Responses from auditors)*

- Lack of information relevant to sub-totals in the statement of profit or loss and OCI: The impact on profit or loss using the equity method of accounting is shown in one-line in the statement of profit or loss and OCI. Thus, it may be difficult to understand significant events that occur in associates, such as recognition of impairment losses.

*(c) Major implementation challenges relating to the equity method of accounting*

13. The ASBJ also questioned whether constituents have faced **significant implementation challenges**, when applying the equity method of accounting.

14. Summary of responses to this question is as follows:

- Half of users stated that the there are some challenges in using information resulting from the use of the equity method of accounting.
- Approximately two third of preparers (70% or 16 out of 23) stated that they have faced practical challenges when applying the equity method of accounting.
- Auditors stated that they have faced practical challenges when performing an audit of information prepared using the equity method of accounting.

15. Respondents who pointed out practical challenges relating to the equity method of accounting provided the following comments:

*(Responses from users)*

- Risks of recognising impairment losses: It is sometimes difficult to anticipate risks of recognising impairment losses for investments in associates, due to a lack of sufficient disclosures regarding the current status of each associate.
- Relationship with cash flows: It is difficult to understand whether profits from the equity method of accounting have actually contributed to cash inflows of the investor.

*(Responses from preparers)*

- <u>Availability of data</u>: It is significantly challenging to obtain financial information that is necessary for the equity method of accounting (including the data necessary for elimination of unrealised gains or losses from transactions between the investor and its associates) in a *timely* manner, given the recent trend of an accelerated financial reporting period.

- <u>Unification of reporting periods</u>: It is significantly challenging to unify reporting periods between an investor and associates, especially given that a financial reporting period is often the end of March in Japan, while the financial reporting period is often the calendar year in many other jurisdictions.

- <u>Unification of accounting policies</u>: It is significantly challenging to unify accounting policies among an investor and associates, given that an investor has *only* a significant influence over the associates. Such challenges are paramount when the associate is a listed entity or a subsidiary of another listed entity.

*(Responses from auditors)*

- <u>Difficulties in auditing judgment</u>: Judgement of accounting treatments is often challenging for the following areas:
  - Whether to measure a previously held interest at far value when investments in associates are obtained in stages;
  - Whether to capitalise acquisition costs for investments in associates; and
  - How to account for the share of other net asset changes for investments in associates.

*(d) <u>Other comments</u>*

16. Other than those stated in paragraphs 5 to 15 of this paper, the ASBJ received the following comments:

*(Responses from users)*

- <u>Consideration of business model</u>: When considering the equity method of accounting, it is important to identify the business model where an investor does not control its investee and it does not aim to realise the return on the investment through movement of market prices.

*(Responses from preparers)*

- <u>Discussion about ‘one-line consolidation’ vs. ‘measurement’</u>: It is important to consider whether the equity method of accounting is ‘one-line consolidation’ or a form of ‘measurement’, but the equity method of accounting should not be considered as either a ‘pure-one line consolidation’ or a ‘measurement basis.’

Rather, it should be considered as a 'mezzanine-type method' that falls in-between consolidation and FV-PL.

- Notion of significant influence: It is important to clarify the conceptual grounds of why a twenty-percent share holdings is supposed to give rise to 'significant influence', where investments of less than twenty-percent of shareholdings is presumed to be otherwise, especially when both investments are held for strategic purposes.

- Impairment testing for investments in associates: Accounting requirements relating to impairment testing for investments accounted for using the equity method of accounting are unclear. This lack of clarity is attributable to the fact that IAS 28 requires many procedures as if an investment in an associate is not a single asset, while it requires that the impairment test should be performed as if the investment as a whole is a single asset.

*(Responses from auditors)*

- Elimination of unrealised gains or losses: It is important to maintain that the relevant share of unrealised gains or losses from transactions between an investor and associates be eliminated, while there is an argument that elimination of unrealised gains or losses would be unnecessary when the equity method of accounting is regarded as part of the measurement.

| Question to the ASAF members |
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| 1. Do you have any questions or comments on the ASBJ's survey? |
| 2. Have you heard of other views that you believe would help the IASB to set the direction for carrying out the research project on this subject? |

**Appendix-I**

# A list of questions in the ASBJ's survey

**Question 1:** Do you think that the information resulting from the application of the equity method for the investee over which the investor has 'significant influence' (especially investor's profits or losses relative to its share of the investee's profits or losses) provides useful information?　In answering the question, please presume that the 'group' concept under existing IFRSs is maintained.

**Question 2:** For respondents who answer 'yes' to Question 1, do you believe that there are any instances where the equity method of accounting does not provide useful information?　In answering the question, please presume that the scope of consolidation and the equity method of accounting specified in existing Standards are maintained.

**Question 3:** Have you faced significant implementation challenges (such as difficulties in obtaining sufficient information), when applying the equity method of accounting?

**Question 4:** Please provide additional comments, if any.