EFRAG STAFF PAPER FOR PUBLIC MEETING

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XX Month XXXX

Dear Mr Faull

Adoption of *Equity Method in Separate Financial Statements* (Amendments to IAS 27)

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the Amendments to IAS 27 *Equity Method in Separate Financial Statements* ('the Amendments'), which were issued by the IASB on 12 August 2014. It was issued as an Exposure Draft in December 2013 and EFRAG commented on that draft.

The objective of the Amendments is to permit entities to use the equity method, as described in IAS 28 *Investments in Associates and Joint Ventures*, to account for investments in subsidiaries, joint ventures and associates in their separate financial statements. The Amendments become effective for annual periods beginning on or after 1 January 2016. Earlier application is permitted, however entities shall disclose that fact.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:

- are not contrary to the principle of 'true and fair view' set out in Article 4(3) of Council Directive 2013/34/EU; and
- meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments in the EU, EFRAG assesses that adopting the Amendments to IAS 27 is conducive to the European public good and, accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix 1 - Basis for Conclusions'.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Roger Marshall
Acting President of the EFRAG Board

APPENDIX 1

BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments to IAS 27 Equity Method in Separate Financial Statements *('the Amendments').*

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for EU endorsement?

1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the Amendments:

(a) are not contrary to the principle of 'true and fair view' set out in Article 4(3) of Council Directive 2013/34/EU; and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 EFRAG also considered, based on a cost-benefit analysis provided in Appendix 3, and on evidence brought to its attention by constituents, whether it would be conducive to the European public good to adopt the Amendments.

Relevance

3 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

4 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

5 EFRAG believes that the equity method has the benefit of allowing the incorporation, over time, of the results of an investee into the investor's financial statements. Consequently, the use of the equity method provides timely and relevant information to users about the investment's performance and economic value. Furthermore, it is also assessed that the equity method can provide relevant information to users, particularly when observable inputs are not available to measure fair value and the cost method might not provide useful information about the income earned by an

investor on an investment because the distributions received may bear little relation to the performance of the investment.

6 EFRAG acknowledges that, as noted in paragraph 2 of Appendix 2, the equity method provides information that is already reflected in consolidated financial statements and other financial statements. However, EFRAG notes that consolidated and separate financial statements reflect different views: the view of a group and the view of an individual entity. More importantly, separate financial statements serve various purposes, many of which are different from those of consolidated financial statements. Therefore, EFRAG believes that the use of the equity method in separate financial statements can provide relevant information, even if the information is already available in consolidated financial statements.

7 EFRAG's overall assessment is that the Amendments would result in the provision of relevant information; and therefore they satisfy the relevance criterion.

Reliability

8 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

9 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation and completeness.

10 In EFRAG's view, the application of the equity method results in information that provides a faithful representation of the financial performance of an investment in a subsidiary, joint venture and associate. This is because, as explained in paragraph 5 above, when a parent or investor applies the equity method to account for its investments, the parent or investor recognises, over time, its share of the profit or loss of the investee in its separate financial statements. Consequently, the use of the equity method provides users of separate financial statements with timely and reliable information about the potential for dividend distribution, the return from the investments and their economic value.

11 EFRAG further notes that the use of the equity method is assessed to result in the provision of reliable information for consolidated financial statements when accounting for associates and joint ventures. EFRAG sees no reason why the same would not apply to the accounting for associates and joint ventures in separate financial statements.

12 EFRAG acknowledges that the Amendments do not provide specific guidance on the application of the equity method to a subsidiary in the separate financial statements of a parent. Therefore, a parent that has elected to apply the equity method to account for its subsidiaries in its separate financial statements will have to follow the methodology outlined in IAS 28 as applicable to an associate or a joint venture (i.e. applying IAS 28 by analogy).

13 EFRAG also acknowledges that this may raise some difficulties in practice, particularly when a parent uses the equity method to account for its subsidiary in its separate financial statements and it loses control of a subsidiary (e.g. sells 65% out of 100%). In such situations, the parent will have to consider both the guidance in IAS 28 and its accounting policies in regard to other categories of investments. The

difficulties in practice arise as IAS 28 was built on the premise that an entity has joint control of or significant influence over an investee, and not control. Difficulties in practice also arise due to the fact that there is already some uncertainty on how to account for an investment when it changes status.

14 Nonetheless, as the equity method is currently widely applied in practice, EFRAG considers that following the methodology in IAS 28 as applicable to an associate or a joint venture to account for subsidiaries in separate financial statements will not add undue complexity to the extent that it may impair reliability.

15 EFRAG's overall assessment is that the Amendments would raise no concerns about risk of error or bias; and therefore they satisfy the reliability criterion.

Comparability

16 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

17 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

18 EFRAG is generally not in favour of introducing additional accounting policy options in IFRS as it potentially decreases comparability of financial information, which is contrary to the need of users.

19 However, EFRAG considers that comparability needs to be balanced against and considered together with relevance and reliability. In this specific case, EFRAG considers that the potential negative effects of adding an accounting policy option are outweighed by the fact that the application of the equity method to account for investments in subsidiaries, joint ventures and associates results, as explained in paragraphs 3 to 15 above, in relevant and reliable information for users of separate financial statements. EFRAG also notes that the Amendments introduce an additional option in an area where options already exist and that any resulting lack of comparability is as much a result of the effect of the different relationships between an investor and its investees as of the different measurement bases applied in separate financial statements.

20 Furthermore, EFRAG notes that, in accordance with paragraphs 13 and 14 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, preparers will not be allowed to freely change their accounting policies.

21 Overall, EFRAG's assessment is that, although the Amendments potentially impact comparability there is a trade-off in terms of comparability, as the Amendments will result in some entities providing information that is more decision-useful to users of separate financial statements. Consequently, EFRAG's overall assessment is that the Amendments, on balance, satisfy the comparability criterion.

Understandability

22 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and

economic activity and accounting and the willingness to study the information with reasonable diligence.

23 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

24 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments are understandable, is whether that information will be unduly complex.

25 The Amendments do not introduce new principles or accounting procedures as they rely on the application of a generally well understood accounting method that is already applied by many entities.

26 EFRAG acknowledges that when an entity opts to use the equity method to account for its investments in its separate financial statements there can be situations where the investor's net assets and profit or loss attributable to the equity method would give a different result when compared to the consolidated financial statements. For example, when considering the impairment testing of goodwill in consolidated financial statements versus impairment testing of an investment accounted for under the equity method where the goodwill is included as part of the carrying amount of the investment. However, as explained in paragraph 6, differences between separate and consolidated financial statements can be understood by users as consolidated and separate financial statements reflect different views: the view of a group and the view of an individual entity.

27 In EFRAG's views, applying the equity method to separate financial statements does not add undue complexity to the extent that it may impair understandability.

28 Therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

True and Fair

29 EFRAG's assessment is that the information resulting from the application of the Amendments would not be contrary to the true and fair view principle.

European public good

30 As explained in Appendix 3, EFRAG has concluded that benefits of the adoption of the amendments to IAS 27 outweigh the costs involved. Furthermore, in the course of its assessment, EFRAG has not identified any adverse effect of the amendments and has therefore concluded that, overall, adopting them was conducive to the European public good.

Conclusion

31 For the reasons set out above, EFRAG's assessment is that the Amendments satisfy all criteria for EU endorsement and EFRAG should therefore recommend their endorsement.

APPENDIX 2

A SUMMARY OF THE AMENDMENTS

Background

1 In the 2011 Agenda Consultation the IASB received requests to reinstate the option to use the equity method in separate financial statements to account for investments in subsidiaries, joint ventures and associates. Those respondents noted that the laws of some countries, particularly in Latin America, require listed companies to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements. Those respondents also noted that the use of the equity method would often be the only difference between separate financial statements prepared in accordance with IFRS and local regulations.

2 Until 2005, entities were allowed to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements. This option was removed with the revision of IAS 27 *Consolidated and Separate Financial Statements* and IAS 28 *Investments in Associates* in 2003. At the time, the IASB noted that the information provided by the equity method was already reflected in consolidated and other financial statements in which investments were accounted for under IAS 28, and that there was no need to provide the same information in separate financial statements.

3 In December 2013, the IASB published for comment the Exposure Draft *ED/2013/10 Equity Method in Separate Financial Statements* and after discussing the feedback received from constituents it decided to proceed with an amendment to IAS 27 which was published on 12 August 2014.

What has changed?

4 The Amendments permit entities to use the equity method, as described in IAS 28, to account for investments in subsidiaries, joint ventures and associates in their separate financial statements.

5 Therefore, with the Amendments, an entity may opt to account for investments in subsidiaries, joint ventures and associates either at cost, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures.* An entity will have to apply the same accounting treatment for each category of investments.

6 In allowing the use the equity method in separate financial statements, a number of additional amendments were made to IAS 27. In particular:

(a) the definition of separate financial statements was changed to incorporate the option to use the equity method to account for investments in subsidiaries, joint venture and associates;

(b) the guidance for investment entities on changes in status (i.e. when a parent ceases to be an investment entity or becomes an investment entity) was changed to take into account the use of the equity method; and

(c) IAS 27 was changed to clarify that dividends shall be recognised in profit or loss unless the entity elects to use the equity method in which case dividends are recognised as a reduction from the carrying amount of the investment.

7 The Amendments also make changes to IFRS 1 *First-time Adoption of International Financial Reporting Standards* to allow a first-time adopter electing to use the equity method to apply the exemption for past business combinations (Appendix C) to the acquisition of the investment and to require a first-time adopter electing to use the equity method to apply paragraphs D16 and D17 of IFRS 1 when the investor and investee have different transition dates.

8 Finally, the Amendments encompass a consequential amendment to the guidance on changes in ownership interest (i.e. if an entity's ownership interest in an associate or a joint venture is reduced) of IAS 28.

When do the Amendments become effective?

9 The Amendments shall be applied retrospectively for annual periods beginning on or after 1 January 2016 with early adoption permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

APPENDIX 3

EFRAG's EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENTS

Introduction

1 As part of assessing whether the Amendments to IAS 27 would be conducive to the European public good, EFRAG has carried out and submitted to public consultation an analysis of costs and benefits that would be derived from adopting them.

EFRAG's initial analysis of the costs and benefits of the Amendments

2 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendments, both in year one and in subsequent years. The results of EFRAG's initial assessment can be summarised as follows:

(a) *Costs* – EFRAG's initial assessment was that the Amendments will not result in significant increased costs for most preparers and users, particularly when considering that the use of the equity method is optional in the separate financial statements prepared under IFRS. However, preparers and users may incur one-off costs when an entity opts to change from 'cost' or 'fair value' to 'equity method' and applies that change retrospectively.

(b) *Benefits* – EFRAG's initial assessment was that, despite the potential impact on comparability of adding an accounting policy option, users are likely to benefit from the Amendments as the information resulting from the Amendments will provide relevant and reliable information about the investment's performance and economic value.

3 EFRAG published its initial assessment and supporting analysis on 23 October 2014. It invited comments by 21 November 2014. In response, EFRAG received eight responses. All respondents agreed with EFRAG's initial assessment that the Amendments meet the technical criteria for endorsement. Five respondents agreed with EFRAG's assessment of the benefits of implementing the Amendments and the associated costs involved for users and preparers. The other respondents did not comment specifically on EFRAG's initial assessment of the costs and benefits of implementing the Amendments in the EU, but supported EFRAG's recommendation that the Amendments be adopted for use in Europe.

EFRAG's final analysis of the costs and benefits of the Amendments

4 Based on its initial analysis and stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of the Amendments is presented in the paragraphs below.

Cost for preparers

5 EFRAG believes that the Amendments will not result in increased costs for most preparers (i.e., they are likely to be cost neutral), particularly when considering that the use of the equity method is optional.

6 However, EFRAG notes that an entity electing to change from 'cost' or 'fair value' to 'equity method' will be required to apply that change retrospectively. In EFRAG's view, an entity may, in some cases, be able to use the information that is used for consolidation of the subsidiary in its consolidated financial statements to apply the equity method retrospectively to an investment in a subsidiary in its separate financial statements. This is because, in those cases, the investor's net assets and profit or loss attributable to the equity holder will be the same in its consolidated and separate

financial statements when the investment is accounted for using the equity method as described in IAS 28.

7 Nonetheless, there are many instances in which applying the equity method to investments in subsidiaries would give a different result compared to consolidated financial statements. Therefore, EFRAG does not believe it will always be possible to derive the carrying amount under the equity method directly from the consolidated financial statements; rather, determining the proper carrying amount may require an additional effort, which will be a one-off cost for those entities that opt to change to the equity method. Still, considering that the use of the equity method is optional, we anticipate that the decision to change to the equity method will be based on other expected benefits that will arise from that change.

8 Overall, EFRAG believes that the Amendments will not result in increased costs to most preparers.

Costs for users

9 EFRAG's assessment is that the Amendments, in general, will not result in significant increased costs to users. Still, when an entity opts to change from 'cost' or 'fair value' to 'equity method' and applies that change retrospectively, users are likely to incur some costs related to updating analyses or databases for comparative information. Users will also have to assess the impact of that change on the financial performance and position of the company.

10 Those users, if any, who prefer to restate the amounts included in each category of investment with the objective of obtaining information in a 'comparable format' may have to incur additional ongoing costs as a result of the introduction of an additional accounting policy option.

Benefits for preparers and users

11 EFRAG's assessment is that the Amendments will not result in significant benefits for all preparers, i.e., it is likely to be neutral for many preparers. However, EFRAG acknowledges that preparers might choose to use the equity method to account for investments in subsidiaries, joint ventures and associates in the separate financial statements when they expect benefits from using that option (e.g. for local compliance purposes) to exceed the costs.

12 Users are likely to benefit from an accounting policy option that allows the incorporation, over time, of the results of an investee into the investor's financial statements. Consequently, the use of the equity method provides timely, relevant and reliable information about the investment's performance and economic value to users of separate financial statements.

13 Overall, EFRAG's assessment is that users are likely to benefit from the Amendments, despite the decreased comparability induced by the accounting policy options, as the information resulting from the Amendments will provide relevant and reliable information about the investment's performance and economic value.

Conclusion

14 EFRAG's overall assessment is that the benefits of the Amendments are likely to outweigh the costs associated with them.