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The Chairman
Australian Accounting Standards Board
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04 February 2014

Dear Mr Stevenson

Ernst & Young's global submissions to the IASB on the Invitation to comment – Exposure Draft ED/2013/10 *Equity Method in Separate Financial Statements (Proposed amendments to IAS 27)*

Please find enclosed Ernst & Young's global submissions to the IASB on the Invitation to Comment.

Yours sincerely

Ernst & Young

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Encl:

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International Accounting Standards Board
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3 February 2014

Dear Board members,

Invitation to comment – Exposure Draft ED/2013/10 *Equity Method in Separate Financial Statements (Proposed amendments to IAS 27)*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on Exposure Draft ED/2013/10 *Equity Method in Separate Financial Statements (Proposed amendments to IAS 27)* (the ED).

We do not object to the inclusion of the equity method as one of the options to account for an entity's investments in subsidiaries, joint ventures and associates in the entity's separate financial statements. Although we do not see a conceptual basis for extending the use of the equity method to the investor's separate financial statements, we believe there is a benefit in removing a difference between IFRS and local requirements that exists in certain countries.

However, we believe the International Accounting Standards Board (IASB) should address the following concerns before finalising the amendment.

- As we have outlined in previous comment letters, we believe the IASB should clarify their view on the conceptual basis of equity accounting. Some people view equity accounting as a one-line consolidation methodology, whilst others consider it to be a valuation methodology. By allowing an entity to use the equity method to measure investments in the separate financial statements, some may conclude that the IASB considers equity method accounting to be a valuation methodology.
- We believe, in relation to investments in subsidiaries, there may be a number of differences in outcome between the consolidated financial statements and the separate financial statements prepared using the equity method, as explained further in our response to Question 1 in the Appendix to this letter. As a result, in many cases, we do not believe that this amendment will necessarily achieve alignment of the net assets and profit and loss from an investment in a subsidiary between the consolidated and separate financial statements.
- If the IASB does permit the use of the equity method for subsidiaries in the investor's separate financial statements, we believe it will have to be an application of the equity method as described in IAS 28, that is applied in the same manner to all equity accounted investments. Therefore we do not agree with the proposed amendment to

paragraph 25 of IAS 28. We explain our concerns further in our response to Question 4 in the Appendix to this letter.

- Although we generally support full retrospective application, we believe the IASB should consider whether the benefit outweighs the cost where investments have been held for a number of years. This is discussed further in our response to Question 2 in the Appendix to this letter.
- We also believe the IASB should consider allowing first-time adopters the deemed cost relief for subsidiaries when using the equity method. This is discussed further in our response to Question 3 in the Appendix to this letter.
- We believe some consequential amendments to IAS 28 will be required to make the amendment to IAS 27 operational. This is discussed further in our response to Question 5.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas on +31 88 407 5035 or Victoria O'Leary on +44 (0) 20 980 0515.

Yours faithfully

Ernst + Young Global Limited

Appendix 1 – Response to questions

Question 1 – Use of the equity method

The IASB proposes to permit the equity method as one of the options to account for an entity's investments in subsidiaries, joint ventures and associates in the entity's separate financial statements.

Do you agree with the inclusion of the equity method as one of the options? If not, why?

We do not object to the inclusion of the equity method as one of the options to account for an entity's investments in subsidiaries, joint ventures and associates in the entity's separate financial statements. Although we do not see a conceptual basis for extending the use of the equity method in the separate financial statements, we believe there is a benefit in removing a difference between IFRS and local requirements that exists in certain countries.

However, if the IASB does proceed with this amendment, we believe the conceptual basis for equity accounting needs to be clarified. As we have commented to the IASB previously, some people view equity accounting as a one-line consolidation methodology, whilst others consider it to be a valuation methodology. Paragraph BC10 of the ED states that 'generally, the investor's net assets and profit or loss attributable to the equity holders of the investor would be the same in its consolidated financial statements and its separate financial statements wherein all investments in subsidiaries, joint ventures and associates are accounted for using the equity method as described in IAS 28'. The paragraph goes on to state that 'there could be situations in which applying the equity method to investments in subsidiaries in separate financial statements would give a different result compared to the consolidated financial statements', and gives one example, being impairment losses arising on goodwill. We believe there are a number of other differences between consolidation and equity accounting that may give a different result, including

- Acquisition costs – in the consolidated financial statements, acquisition costs on a business combination are expensed in the period they are incurred, but are included in the cost of the investment for equity accounting.
- Loss making subsidiaries – the consolidated financial statements include full recognition of losses of a subsidiary. However, under equity accounting, an entity discontinues recognising losses once its share of the losses equals or exceeds its interest.

In Appendix 2 to this letter, we include a copy of a letter sent to the IASB in July 2009 where we outline a number of other differences between equity accounting as a measurement method and equity accounting as one-line consolidation. All of them may lead to differences between the results in the separate and consolidated financial statements.

Given the number of issues that arise, we believe that in many cases, this amendment will not necessarily result in alignment of the investor's net assets and profit or loss in the consolidated and separate financial statements.

Question 2 – Transition provisions

The IASB proposes that an entity electing to change to the equity method would be required to apply that change retrospectively, and therefore would be required to apply IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Do you agree with the proposed transition provisions? If not, why and what alternative do you propose?

Although we generally support full retrospective application, we are concerned that the cost of doing so may outweigh the benefit, particularly where investments have been held for a number of years. As highlighted in our response to Question 1, we believe there are a number of situations where the amounts included in the consolidated financial statements may differ from those that would be used for equity accounting in the separate financial statements. We believe it may be impractical for entities to obtain the information to make those adjustments in prior periods.

Therefore, we suggest the IASB consider allowing entities to use the amounts recognised in the consolidated financial statements for associates, joint ventures and subsidiaries as the opening balances when the amendment is first applied, and apply the equity method going forwards from that date.

Question 3 – First-time adopters

The IASB does not propose to provide any special relief for first-time adopters. A first-time adopter electing to use the equity method would be required to apply the method from the date of transition to IFRSs in accordance with the general requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Do you agree that a special relief is not required for a first-time adopter? If not, why and what alternative do you propose?

We believe that special relief is required for a first-time adopter.

Paragraph D15 of IFRS 1 permits a first-time adopter electing the cost method to measure investments in subsidiaries, associates and joint ventures in its separate financial statements at deemed cost in its opening statement of financial position. The Basis for Conclusions to IFRS 1 explains the rationale for this exemption to be the difficulty and cost in applying IAS 27 retrospectively. We believe the same argument is true when an entity applies the equity method. Therefore, we believe the IASB should consider amending paragraph D15 of IFRS 1, to allow a first-time adopter electing to use the equity method in its separate financial statements, to use deemed cost (which includes the previous GAAP carrying amount at that date) in the opening IFRS financial statements.

Paragraph D17of IFRS 1 states '… Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments'. As explained in our response, to Question 2, we believe that there are a number of situations where the amounts included in the consolidated financial statements may differ from those that would be used for equity accounting in the separate financial statements and it may be impractical for entities to obtain the information to make those adjustments in prior periods. Therefore, we believe the IASB should consider amending paragraph D17 to allow a parent entity already applying IFRS in their consolidated financial statements to use the net asset value of those subsidiaries in the consolidated financial statements, as the deemed cost at the date of transition in the separate financial statements.

Question 4 – Consequential amendment to IAS *28 Investments in Associates and Joint Ventures*

The IASB proposes to amend paragraph 25 of IAS 28 in order to avoid a conflict with the principles of IFRS 10 *Consolidated Financial Statements* in situations in which an entity loses control of a subsidiary but retains an ownership interest in the former subsidiary that gives the entity significant influence or joint control, and the entity elects to use the equity method to account for the investments in its separate financial statements.

Do you agree with the proposed consequential amendment? If not, why?

We do not agree with the proposed amendment to paragraph 25 of IAS 28.

We do not understand how the proposed consequential amendment would address the issue raised in paragraph BC11. Paragraph BC 11 refers to the potential conflict between the remeasurement of the retained interest in a former subsidiary when control is lost under IFRS 10 and the requirement in IAS 28 to continue to account for the retained investment using the existing carrying value. However, we do not understand how this conflict would be resolved by the proposed amendment which does not address the accounting for the loss of control of a subsidiary. We also note that a similar conflict would occur on gaining control of an associate or joint venture.

It is unclear to us whether the amendment is trying to achieve consistency between the separate and consolidated financial statements. If so, in our view a number of differences between the two will still remain, as described in our response to Question 1 above. We do not believe it is appropriate to address one difference but not others. If the IASB extends the equity method to investments in subsidiaries in the investor's separate financial statements, we believe it must be the same equity method that is applied to all investments, without modification for investments in subsidiaries. For example, if an entity has a 40% investment in an associate and that investment is reduced to 35% and continues to be equity accounted, the retained interest of 35% is not remeasured. Notwithstanding the requirements of IFRS 10 for remeasurement to fair value of the retained ownership interest in the consolidated financial statements, we believe that in the separate financial statements, if an entity has an investment in a subsidiary of 55% and this is reduced to 45% (with a loss of control) and the investment continues to be equity accounted, then this should not trigger a remeasurement. I.e. loss of control for IFRS 10 purposes should not affect the accounting by the investor in its separate financial statements if it uses the equity method. We believe the same argument also applies when an entity has an investment that does not give control and then increases that investment to obtain control.

Question 5 – Other comments

Do you have any other comments on the proposals?

The IASB is not proposing to amend IAS 28 (other than paragraph 25). However, we are concerned that some of the paragraphs in IAS 28 as drafted will not make sense for entities applying the equity method to subsidiaries in the separate financial statements. For example, paragraph 2 of IAS 28 states 'This Standard shall be applied by all entities that are investors with joint control of, or significant influence over, an investee'. However, the optional exemption in IAS 27 would extend the scope to investments in subsidiaries in the separate financial statements.

Similarly, paragraph 22 states that 'an entity shall discontinue the use of the equity method from the date when its investment ceases to be an associate or joint venture as follows: (a) if the investment becomes a subsidiary, the entity shall account for its investment in accordance with IFRS 3 and IFRS 10.' However, this will not be the case in the separate financial statements.

We suggest that the IASB review the relevant paragraphs in IAS 28 before finalising this amendment, and consider whether consequential amendments are necessary in order to reflect the intention of the amendment to IAS 27.

Appendix 2 – Equity accounting letter to the IASB July 2009

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International Accounting Standards Board
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22 July 2009

Dear IASB Member

Re: Application of Equity Accounting

Equity accounting has existed within the IFRS literature for many years as the method to account for an investment in an associate, and one of the methods to account for an interest in a jointly controlled entity. Proposals also exist for this method to be the sole method of accounting for an interest in a jointly controlled entity.

However, IAS 28 itself does not clarify the exact purpose of equity accounting. Accordingly, different views have emerged as to whether equity accounting is a form of consolidation or merely a measurement technique. We commented on this in our comment letter to ED 10 *Consolidated Financial Statements* dated 23 March 2009.

The equity accounting method is set out in IAS 28 *Investment in Associates*. More specifically, paragraph 20 of this standard notes that:

- many procedures appropriate for the application of the equity method are similar to the consolidation procedures described in IAS 27 *Consolidated Financial Statements*.
- the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.

Accordingly, there is widely accepted practice to apply business combination and consolidation principles to equity accounting. We note a number of these situations in Appendix A to this letter.

In April 2009, the Board issued its second omnibus of annual improvements. This omnibus included amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRIC 9 *Reassessment of Embedded Derivatives*. The basis for conclusion to these amendments makes references to accounting for associates that contradict paragraph 20 of IAS 28, are inconsistent with current practice and have added to the confusion as to what exactly the equity accounting method is, and therefore how to account for the transactions outlined in appendix A. It is now not clear how paragraph 20 of IAS 28 should be applied. Those references are reproduced below:

BC24D of IAS 39 – relating to the amendment to paragraph 2(g) states:

'The Board noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures.'

BC5D of IFRIC 9 – relating to the scope of the interpretation states:

'In its redeliberations, the Board confirmed its previous decision that no scope exemption in IFRIC 9 was needed for investments in associates. However, in response to the comments received, the Board noted that reassessment of embedded derivatives in contracts held by an associate is not required by IFRIC 9 in any event. The investment in the associate is the asset the investor controls and ecognizes, not the underlying assets and liabilities of the associate.'

Appendix A to this letter notes the areas where difficultly has arisen in applying the equity accounting method, and where the above statements made in the annual improvement process will add further confusion. We also note that IFRIC have been addressing some matters that relate to equity accounting, that ultimately hinge on the same question – what is the equity accounting method supposed to be represent?

Statements such as those made by the Board in the basis for conclusions of annual improvements will not influence equity accounting practices since these practices have emerged over a long period and are widely accepted. We reiterate the statement made in our comment letter to ED 10, that the Boards take a holistic look at accounting for associates, and amend IAS 28 to eliminate the current diversity and the future likely diversity that will be created

Should you wish to discuss the contents of this letter further, please contact Lynda Tomkins on 0207 951 0241 or Leo van der Tas on 0207 951 3152.

Yours faithfully

Ernst & Young

Appendix A – Areas where equity accounting is problematic

Topic	Description
Common control transactions with associates	Entities under common control transfer an interest in an associate between themselves. In the sub-consolidated statements, two views have developed: Equity accounting is a method of consolidation – The exemption in IFRS 3 applies. Equity accounting is a method of measurement – The exemption in IFRS 3 does not apply.
Associate's equity holding in the investor	An investor accounts for its associate using the equity method. The associate has equity interest in the investor, but is not applying the equity method to its reciprocal holding. The consolidation principles of IAS 27 require the elimination of intragroup revenues and expenses, which includes income arising from investments by a subsidiary in its parent. Therefore applying the consolidation principles, the gains from the reciprocal holding are eliminated.
Cross holdings between associates	An investor has two associates which it accounts for using the equity method. The associates also have an ownership interest in each other. The consolidation principles of IAS 27 require the elimination of intragroup revenues and expenses, which includes income arising from investments by a subsidiary in its parent. Therefore applying the consolidation principles, the gains from the reciprocal holdings are eliminated.
Profits on transactions between associates	An investor has two associates which it accounts for using the equity method. The associates have transferred an asset between them generating a gain in one associate. Paragraph 22 of IAS 28 refers only to the elimination of upstream and downstream transactions. However, the consolidation principles of IAS 27 require the elimination of intragroup revenues and expenses. Therefore applying the consolidation principles, the unrealized profit is eliminated.
Elimination of downstream gains in excess of investment	An investor purchases an asset from an associate. The unrealized profit to be eliminated will result in a negative carrying value of the investment. Two views have developed: Equity accounting is a method of consolidation – The unrealized profit is eliminated in full. Equity accounting is a method of measurement – The unrealized profit is eliminated only to reduce the investment to zero.

Topic	Description
Changes in ownership interest of an associate without a change in the nature of the relationship.	An investor may increase its ownership interest in an associate or may dilute its interest in the associate, yet the nature of the investment remains as an associate. The latter was discussed also by IFRIC several years ago. Dilution of interest – two views have developed: Equity accounting is a method of consolidation – The principles of IAS 27 apply and this is recognized in equity. Equity accounting is a method of measurement – This is recognized in the profit or loss. Increase in interest – several views have developed: Equity accounting is a method of consolidation – The principles of IAS 27 apply and this is recognized in equity. Equity accounting is a method of measurement – This is recognized in the profit or loss or there is no adjustment at all.
Step acquisition of an associate	An investor gains significant interest through a series of acquisitions of ownership interest. This primarily hinges on the definition of cost rather than equity accounting, however the view taken on equity accounting has influenced whether or not the principles within IFRS 3 may be applied.
Contingent consideration	In some cases an investor acquires an ownership interest where contingent consideration is payable in the future. As a result of amendments to IFRS 3R questions have arisen as to how this should be accounted for when applying equity accounting. Similar to the above issue, it is more a question as to what 'cost' is, and any decision made has further implications relating to contingent consideration for asset acquisitions. However the view taken on equity accounting may potentially influence whether or not the principles within IFRS 3 may be applied.