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The Use and Usefulness of Equity Accounting in Australia

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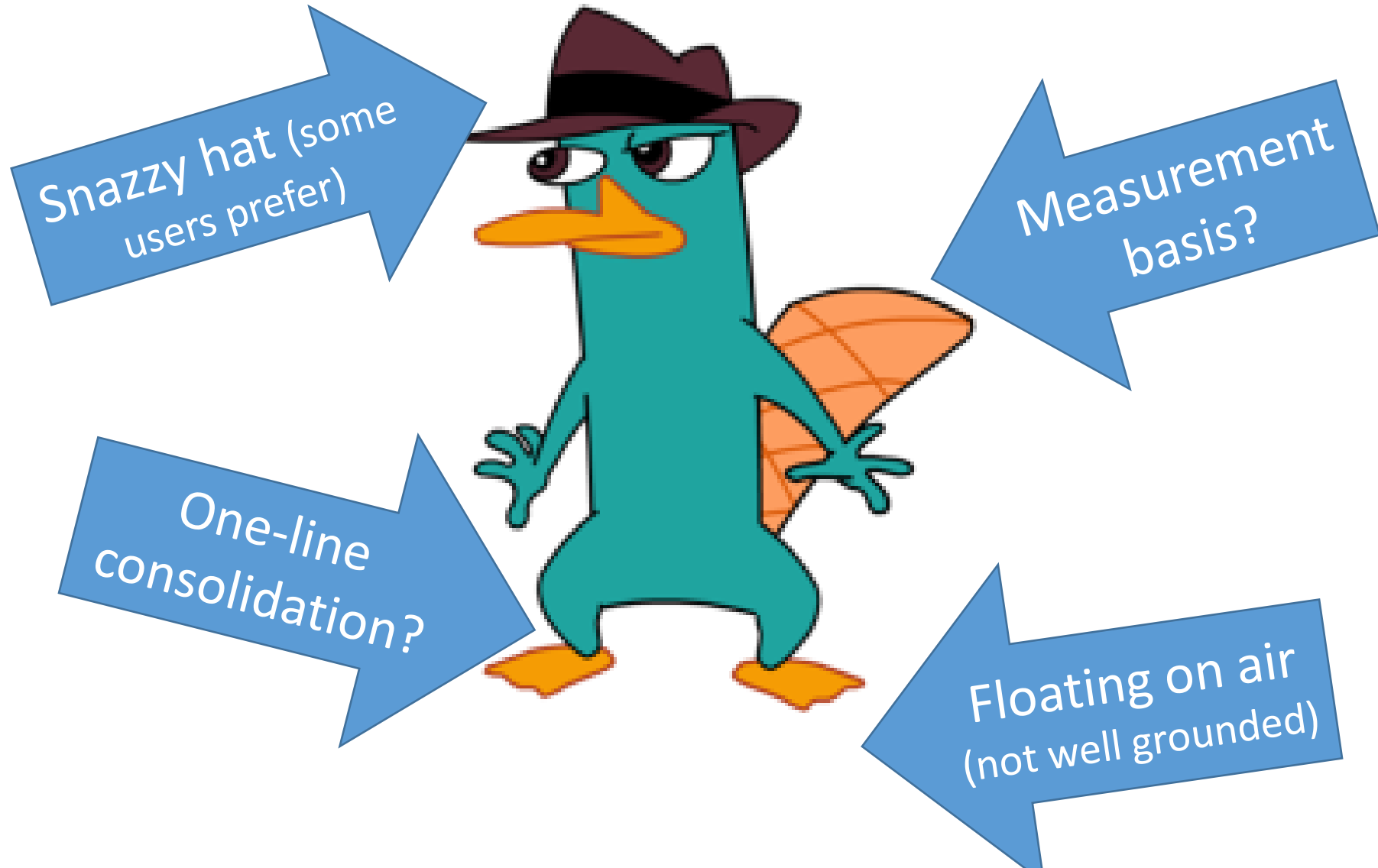
What is Equity Accounting?

- Recognise the investment at cost and then adjust for the investor's share of the post-acquisition change in net assets
- Share of investees net profit (OCI) is recognised in investors net profit (OCI)
- Distributions decrease the investment and profit on inter-company transactions are eliminated
- IAS 28 requires it for associates and JVs
- Varied history; a consolidation method; for excluded subsidiaries; associates; JVs
 - At times has been voluntary

When to use equity accounting?

- Control (50%?) = consolidation
- Significant influence (20%?) = equity accounting
- If neither then financial instrument accounting (fair value)
 - In summary alternatives are full consolidation, proportional consolidation, and fair value
- Question: Is equity accounting a consolidation method or a measurement basis?
 - Where should the gain go?

Conceptual inconsistencies – Perry the Platypus



Not just our opinion!

- *“Whether the equity method is considered to be primarily a method of consolidation, a measurement basis or a hybrid that has characteristics of both, could affect the way standard setters further develop the equity method in the future.”* (EFRAG, 2014)
- *“There have been many controversies regarding the current IAS 28 ‘Investments in Associates and Joint Ventures.’ The current IAS 28 is criticized for not properly providing specific guidance in numerous cases, and even when the guidance is given, it is often vaguely stated”* (KASB, 2014)
- Constituent feedback on IASB’s 2011-2012 Agenda Consultation revealed the divergent views on the equity accounting (conceptual basis, scope, requirements)

Recent issues Exposure Draft ED/2019/7

Figure 1—Summary of a statement of profit or loss

Revenue	X	Operating
Operating expenses	(X)	
Operating profit or loss	X	
Share of profit or loss of integral associates and joint ventures	X	Integral associates and joint ventures
Operating profit or loss and income and expenses from integral associates and joint ventures	X	
Share of profit or loss of non-integral associates and joint ventures	X	Investing
Income from investments	X	
Profit or loss before financing and income tax	X	
Interest revenue from cash and cash equivalents	X	Financing
Expenses from financing activities	(X)	
Unwinding of discount on pension liabilities and provisions	(X)	
Profit or loss before tax	X	

Prior Literature

- Firms view equity accounting as material
 - Clustering around 'bright line' thresholds and differences between voluntary users (Comiskey & Mulford, 1986; Morris & Gordon, 2006; Bøhren & Haug, 2006)
- Understood by analysts?
 - No difference in forecast attributes for Spanish JCEs that use equity accounting vs proportionate consolidation (Giner Inchausti *et al.*, 2017), but US companies with more equity accounting have greater analyst errors (Lee *et al.*, 2013)
- Not much evidence on use in practise (location, disclosures)
- Mixed evidence on its usefulness
 - FV is more value relevant than equity accounting (US: Graham *et al.*, 2003a), proportionate consolidation is (Canada: Graham *et al.*, 2003b). Equity method is more value relevant than either (Australia: Tutticci, 2002), than proportionate consolidation (HK: So *et al.*, 2018), than cost (Korea: KASB, 2014).



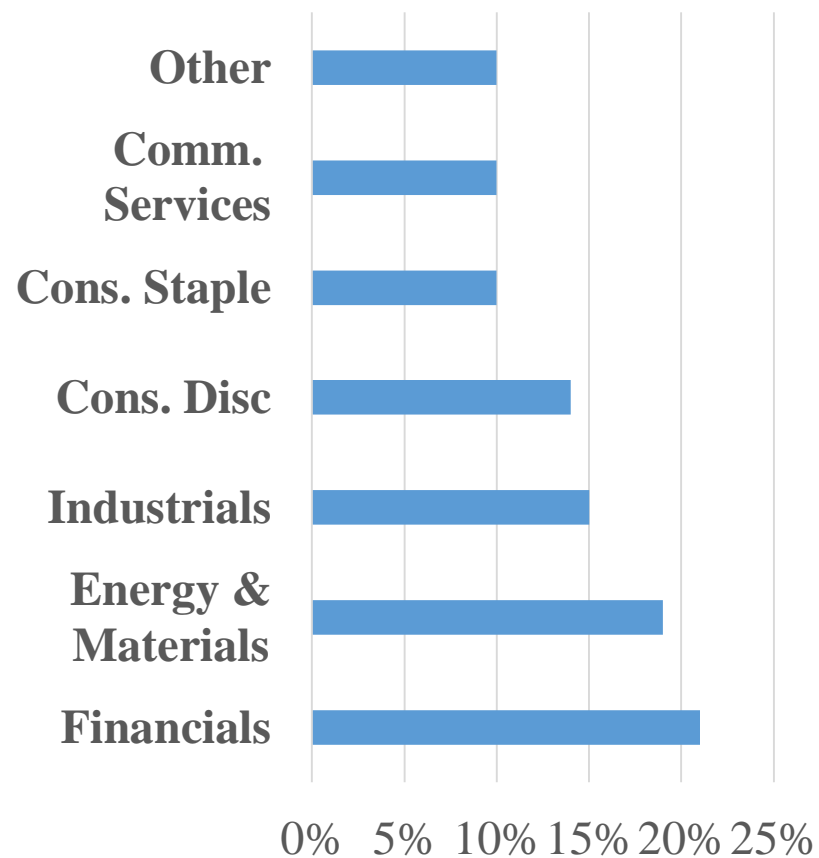
Research questions

- What is the use and diversity of the equity method?
- Is it useful?

- Largest 200 companies on ASX
- Download their 2015 and 2018 report
- 72 (82) have associates at the end of 2015 (2018)

Sample statistics

- 4 Associates
- Investment in Associate \$370m (5.7% of TA)
- Share of Profit \$34m (13.7% of NPAT)
- Large range!

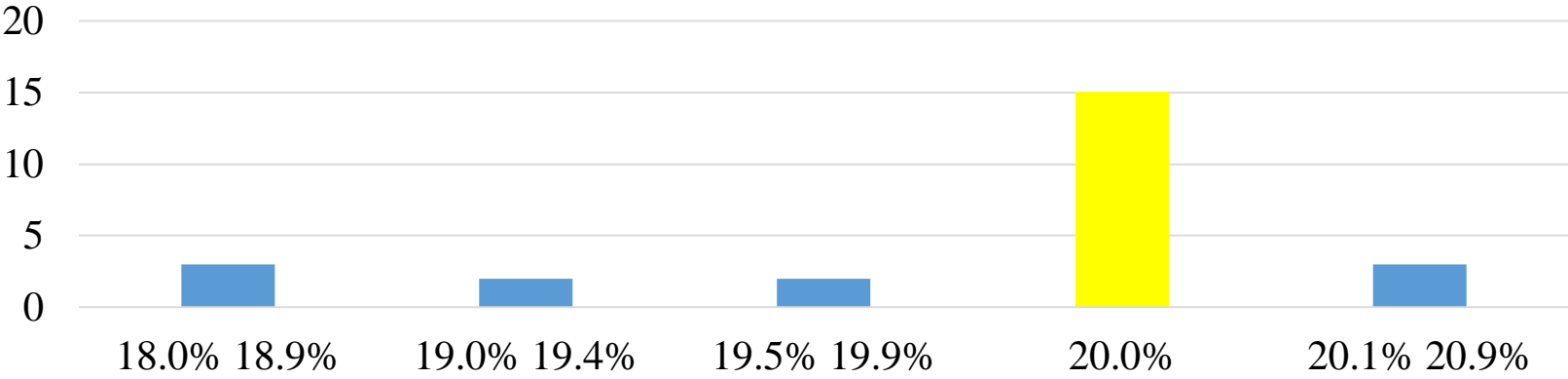


Summary Statistics

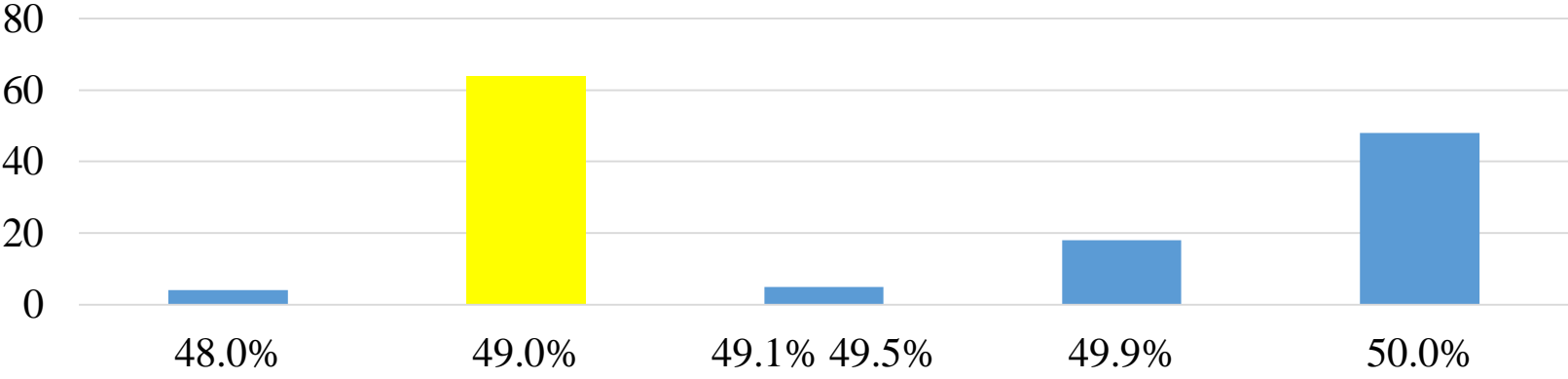
	Mean	Median	S.D.	Min	Max
Number of associates	4.24	2	6.74	1	44
Ownership stake	37%	40%	15%	1%	100%
Investment in associate (\$000)	369,612	40,300	810,420	0	5,440,000
Investment in associate – % of total assets	5.7%	0.8%	14.1%	0.0%	99.4%
Share of associates profit (\$000)	34,445	1,703	126,881	-339,300	850,402
Share of associates profit – % of NPAT	13.7%	2.8%	29.8%	0.0%	184.3%
Share of associates OCI	4,817	1,424	15,922	-14,000	59,000
Share of associates OCI - percent	0.01%	0.00%	0.05%	-0.09%	0.17%

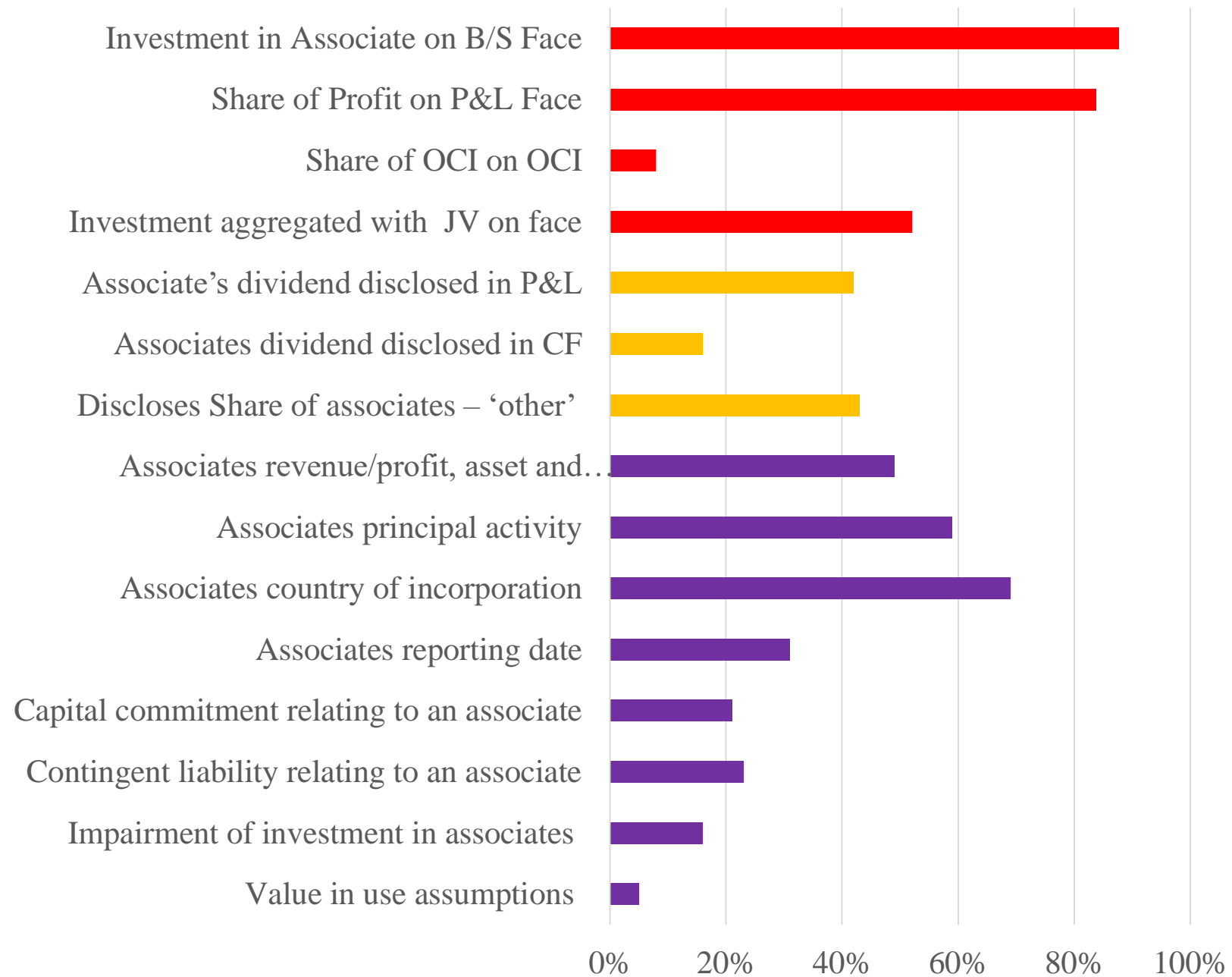
Revealed demand for Equity Accounting

Ownership interest in associates around 20%

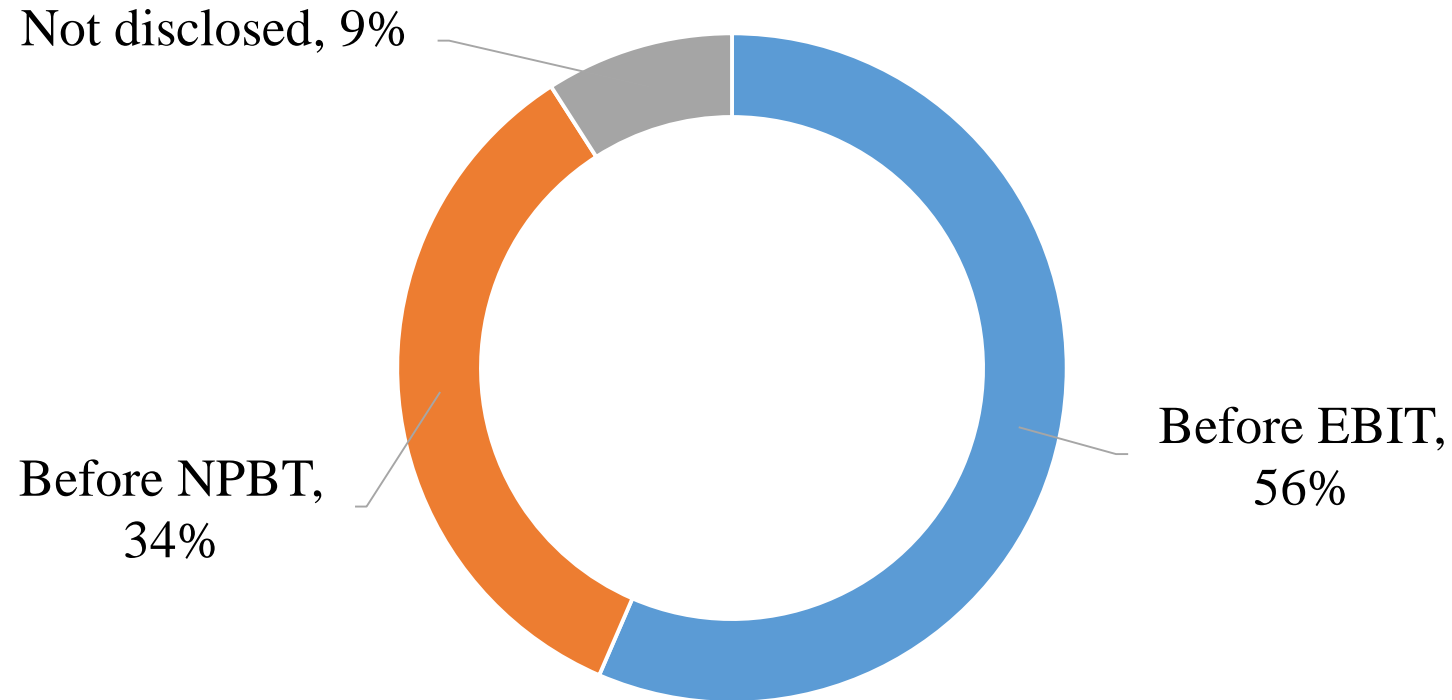


Ownership interest in associates around 49%





Share of Profit from Associate location



- IASB (2019b) report 72% locate it before operating income

Determinants of disclosures

	Rev./ Asset/ Liab.	Principal activity	Country of incorp.	Reporting date	Before EBIT
<i>Listed</i>	✓	✓	✓	✓	✓
<i>AverOwn</i>	✓				✓
<i>InvAssoc%</i>	✓	✓	✓		
<i>LnMCap</i>					✓
<i>TLTA</i>	✓		✓		✓
<i>Loss</i>					
<i>Board</i>				✓	✓
<i>AudComm</i>		✓			

- Greater disclosure for more important associates
- Guidance on integral will be difficult

Is Equity Accounting useful?

- Is equity method more useful than fair value or proportionate consolidation?
- Identify listed associates over 2015 to 2018 (N = 62) that have a separate equity method value
- Test association of investee's valuation with investor's share prices (Ohlson model)
- Investment in Associate is not value relevant
- Investors share of associate's market value (FV) or net total assets of (proportionate consolidation) are
- Null result on whether associate is integral

- Limitation: small sample size, information preference of users (Chaebols?), comparing to active market unfair?



Policy Implications <https://www.ifrs.org/projects/work-plan/equity-method/>

- Should we do it? (Conceptual basis review)
 - Not useful*
- Who should do it? (Scope review)
 - Company demand
- How should we do it? (Requirements review)
 - Diversity in disclosure and location – standardise?
 - Digital reporting (XBRL) to allow Core & More reporting to drill down via IFRS taxonomy?
- Variation in disclosing before EBIT (ED/2019/7)
 - Identifying integral will be complex
 - Should only integral do it?

Thank you for listening,
we will not “duck” your
questions

