EFRAG
European Financial Reporting Advisory Group

Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

28 March 2014

Dear Hans,

**Re: Amendments to IAS 28 – Equity Method: Other Changes in the Investor's Share of the Investee's Net Assets**

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to express concern before publication of the above amendments.

This letter is intended to contribute to the IASB's process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

At the March 2014 meeting of the Accounting Standards Advisory Forum ('ASAF'), EFRAG raised several concerns regarding the amendments, in particular that they would conflict with a recently set, well-accepted and fundamental principle of IAS 1 *Presentation of Financial Statements* that only transactions with equity holders impact equity directly. It therefore risks creating internal inconsistencies within IFRS.

Other ASAF members indicated similar concerns and indeed the decision to continue with the proposals as exposed was despite opposition from a significant majority of respondents to the IASB's due process.

At the ASAF meeting, we offered assistance in identifying an approach that would not conflict with IAS 1. The appendix to this letter sets out a potential accounting model and an analysis of how it would apply in various circumstances. We believe that the suggested approach:

- is consistent with the fundamental principle of IAS 1 that only transactions with equity holders impact equity directly;
- avoids accounting differently for economically similar transactions (direct and indirect acquisitions and disposals);
- ensures that economic losses are not deferred in equity indefinitely;
- addresses share-based payment and share warrant transactions (a key reason given by the IASB for rejecting the IFRS Interpretations Committee's model);
- incorporates the recent decision of the IASB that an investor should only recognise changes in its share of the investee's net assets; and
- is broadly consistent with generally accepted accounting practice under IFRS.

If you would like to discuss our proposed alternative model further, please do not hesitate to contact Hocine Kebli, Benjamin Reilly or me.

Yours sincerely,

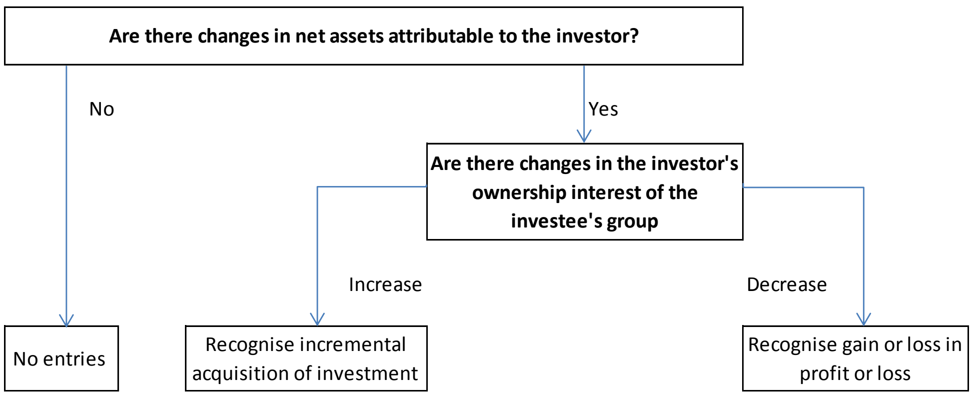
Françoise Flores
**EFRAG Chairman**

## APPENDIX

1 This appendix to this letter sets out an alternative accounting model for other changes in an investor's share of an investee's net asset. In addition, it provides an analysis of how this model would apply in various circumstances; including those considered by the IASB during the development of the amendments.

2 The information requirements of the model are consistent with those already required for a proper application of the equity method and it would therefore not be expected to give rise to significant implementation challenges.

3 The following is an overview of the alternative model:




4 The key principles underlying the alternative model are the following:

(a) Principle A – Only changes in net assets that are *attributable to the investor* should be recognised (e.g. an investor should not account for the issue of another class of equity instruments by the investee to third parties);

(b) Principle B – Where an investor's ownership interest in the investee is reduced (directly or indirectly), the impact of the change should be accounted for as a partial disposal and recognised in profit or loss of the investor; and

(c) Principle C – Where an investor's ownership interest in the investee increases (directly or indirectly), the impact of the change should be accounted for as an incremental purchase of the investee and recognised at cost. This principle was described as 'the zero cost acquisition approach' in IASB and IFRS Interpretations Committee papers.

5 As an outcome of the model, indirect ('deemed') acquisitions and disposals by an investor are accounted for the in the same way as direct acquisitions and disposals.

6 In addition, the above principles ensure that economic losses are not deferred indefinitely in equity.

### Application of the proposed model

7 The table below illustrates the application of the proposed model to various circumstances, including those that were considered by the IFRS Interpretations Committee in developing its original proposal. 'H' is the investor and 'A' is the equity accounted investee.

| Scenario | | Are there changes in net assets attributable to the Investor? | Are there changes in the investor's ownership interest in investee's group? | Accounting by investor | See para |
|---|---|---|---|---|---|
| **Share transactions by investee** | - Investee issues additional shares to third party in exchange for an asset (e.g. cash) | - Yes | - Decrease | - Gain/loss in P&L | 8 |
| | - Investee buys back shares from other investors | - Yes | - Increase | - Incremental acquisition of investment | 9 |
| **Share-based payments by investee** | - Investee issues share options in exchange for an item of PPE | - Grant date: No<br>- Exercise date: Yes<br>- Lapse: Yes | - None<br>- Decrease<br>- None | - No entries<br>- Gain/loss in P&L<br>- Gain in P&L | 11 |
| | - Investee issues stock options for employees | - Grant Date: No<br>- Vesting period: No<br>- Exercise: Yes<br>- Lapse: Yes | - None<br>- None<br>- Decrease<br>- None | - No entries<br>- No entries<br>- Gain/loss in P&L<br>- Gain in P&L | 15 |
| **Options and warrants written by investee on its own equity** | - Investee writes put option over its own equity instruments in exchange for an asset (e.g. cash) | - Issuance date: No<br>- Exercise date: Yes<br>- Lapse: Yes | - None<br>- Increase<br>- None | - No entries<br>- Incremental acquisition of investment<br>- Gain in P&L | 18 |
| | - Investee issue warrants in exchange for an asset (e.g. cash) | - Issuance date: No<br>- Exercise date: Yes<br>- Lapse: Yes | - None<br>- Decrease<br>- None | - No entries<br>- Gain/loss in P&L<br>- Gain in P&L | 23 |
| **Investee's transactions affecting its NCIs** | - Investee sells shares in its subsidiary | - Yes | - Yes (decrease in investor's ownership interest in investee's consolidated net assets) | - Gain/loss in P&L | 26 |
| | - Investee buys shares in its subsidiary | - Yes | - Yes (increase in investor's ownership interest in investee's consolidated net assets) | - Incremental acquisition of investment | 29 |

## Share transactions by investee

*Example 1: Investee (Entity A) issues additional share capital to third party for an asset*

8 The investor's ownership interest in the investee is reduced and therefore Principle B applies. As a result of the indirect disposal of a portion of the investor's shareholding in Entity A, Entity H has realised a gain or loss when comparing the carrying value of the part of Entity A that it has deemed to have disposed of to the change in the net assets of Entity A.

*Example 2: Investee (Entity A) share buy-back from other investors*

9 The investor's ownership interest in the investee increases and therefore Principle C applies. The impact of the change is accounted for as an incremental purchase of the investee.

10 The investor recognises a net change of nil in the investment in associate because it:

(a) debits investment in associate (additional interest acquired); and

(b) credits investment in associate (decrease in investor's share of investee's net assets). This entry represents the cost of the acquisition.

**Share-based payments by investee**

*Example 3: Investee (Entity A) issues share options in exchange for an item of Property, Plant and Equipment (PPE)*

11 The item of PPE is recognised in accordance with IAS 16 *Property, Plant and Equipment*, with cost measured in accordance with IFRS 2 *Share-based payment.* The credit entry for the share option payment is to the investee's share-based payment reserve. This share-based payment reserve is a part of the investee's equity over which the investor has no claim and Principle A applies. Therefore, there is no other net asset change to recognise.

12 The item of PPE is depreciated normally, and the investor recognises its share of this as with any other expense.

13 Upon exercise of the share options, the investor is diluted. Principle B applies and the investor accounts for this change in their share of the investee's net assets as a dilution gain or loss.

14 If the options lapse, the investor recognises a gain (in line with Principle A), as there is an increase in their share of the investee's net assets. This is similar to the accounting that would result if a cash-settled share-based payment award were to lapse.

*Example 4: Investee (Entity A) issues equity-settled share options for employee services*

15 The accounting is similar to the PPE example above, and assumes that the share-based payment for employee services is not capitalised as part of the costs of an asset.

16 The debit entry of the share-based payment is recognised in profit or loss and is picked up by the investor (Entity H) as part of its share of the investee's profit or loss. The credit entry is to a part of equity that the investor has no claim over and therefore is not accounted for (Principle A applies).

17 Upon exercise of the share options, the accounting described in paragraph 13 applies. If the options lapse, the accounting described in paragraph 14 applies.

**Options and warrants written by investee on its own equity**

*Example 5: Put option written by investee (Entity A) over its own equity instruments in exchange for an asset*

18 The investee recognises a debit for the asset (e.g. cash) received, a credit for the present value of the liability (in accordance with paragraph 23 of IAS 32 *Financial Instruments: Presentation)* and a balancing debit to equity.

19 Although the investee has recognised a debit to equity, there has been no change in the investor's share of the investee's net assets when the put option is written as Principle A applies and this debit is not part of the net assets attributable to the investor.

20 Changes in the liability recognised in profit or loss are also attributable to that new class of equity and so during the life of the put option; it does not cause a change in the share of the investee's net assets attributable to the investor.

21 If the put option is exercised, the investee buys back its own shares and Principle C applies. The accounting is similar to the share buyback in Example 2 above.

22 If the put option lapses, the separate class of equity no longer exists. Principle A applies and the investor recognises a gain for its share of the premium received.

*Example 6: Warrants written by investee (Entity A) for an asset*

23 Similar to the written put option example, there has been no change in the investee's equity attributable to the investor when the warrants are written. Therefore the investor does not record any entries (Principle A applies).

24 If the warrants are exercised, the investee issues more shares and the investor has been diluted. Principle B applies and the accounting is similar to the share issue in Example 1 above.

25 If the warrants lapse, the separate class of equity no longer exists. Principle A applies and the investor recognises a gain for its share of the premium received.

**Investee's transactions affecting its NCIs**

*Example 7: Investee (Entity A) sells stake in its subsidiary, which affects NCI*

26 Although the investor's percentage ownership in the investee has not changed, there has been a change in the investee's consolidated equity attributable to ordinary shareholders of the investee.

27 The transaction is similar to a partial disposal of a part of the investee. In fact, if the investee (Entity A) had no assets or liabilities other than its investment in subsidiary then the economic effect of the transaction would be identical. It stands to reason that requiring the same accounting treatment would avoid a distinction without a difference.

28 Therefore, similar to Example 1, Principle B applies. If the amount paid is more (less) than net asset value, the net assets attributable to the investor increase (decrease) and a gain (loss) should be recognised.

*Example 8: Investee (Entity A) buys additional ordinary shares in its subsidiary from its non-controlling interest*

29 Similar to the sale example above, there has been a change in the investee's consolidated net assets that is attributable to ordinary shareholders.

30 The transaction is a partial acquisition of a part of the investee and therefore Principle C applies. The investor recognises the impact of the change as an incremental cost of its investment.