European Financial Reporting Advisory Group

[Draft Comment Letter]

Comments should be submitted by 28 January 2013 to Commentletters@efrag.org

22 March 2013

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

Dear Sir/Madam,

Re: Exposure Draft ED/2012/3 Equity Method: Share of Other Net Asset Changes

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft (ED/2012/3) *Equity Method: Share of Other Net Asset Changes* (proposed amendments to IAS 28), issued by the IASB on 22 November 2012 (the 'ED').

This letter is intended to contribute to the IASB's due 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.

EFRAG agrees that diversity in practice exists on how investors should recognise their share of the changes in the net assets of an investee that are not recognised in profit or loss or other comprehensive income of the investee, and are not distributions received ('other net asset changes'). Therefore, EFRAG supports the IASB's efforts to address the issue.

EFRAG members have different views on the accounting for other net asset changes by an investor, which can be summarised as follows:

- View 1: Agree that other net asset changes are recognised in equity and reclassified to profit or loss when the investor discontinues the use of the equity method (the IASB's proposal).
- View 2: The investor should *only* recognise changes in the investee's net assets that arise from profit or loss, other comprehensive income (OCI) and distributions received. Under this view, reclassification would not be necessary.
- View 3: The investor should account for the investee's other net asset changes that result in indirect decreases and increases in the investor's ownership interest, in the same way as actual disposals and acquisitions of interest in the investee. Under this view, reclassification would not be necessary.

Our detailed comments and responses to the questions in the ED are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista or me.

Yours sincerely,

Françoise Flores

EFRAG Chairman

APPENDIX 1

Notes to constituents

1 *The objective of the proposed amendments is to provide additional guidance to IAS 28 (2011)* Investments in Associates and Joint Ventures *on the application of the equity method. Entities would be required to apply the proposed amendments retrospectively.*

2 *Specifically, the amendments propose that an investor should recognise directly in equity its ownership interest of changes in the investee's equity that do not arise from profit or loss, other comprehensive income (OCI) or distributions received – 'other net asset changes'. Such changes include those arising from movements in the share capital of the investee (e.g. when the investee issues additional shares to third parties or buys back shares from third parties) and movements in other components of the investee's equity (e.g. when an investee accounts for an equity settled share-based payment transaction).*

3 *Current IAS 28 (2011)* Investments in Associates and Joint Ventures *is silent on how to apply the equity method to the investor's percentage interest of other net asset changes. More specifically:*

(a) *The definition of the equity method in paragraph 3 of IAS 28 (2011) indicates that all changes in the net assets of an investee should be recognised by the investor; whereas*

(b) *The mechanics of the equity method described in paragraph 10 of IAS 28 (2011) are silent on whether, and if so, where, the investor should account for its ownership interest of other net asset changes.*

4 *Some view paragraphs 3 and 10 to be inconsistent with each other, or at least unclear. In this respect, the IASB states in paragraph BC1 of the ED that this perceived inconsistency was introduced as a result of the consequential amendment below that was made as part of the 2007 revision to IAS 1* Presentation of Financial Statements*:*

> *'11 Under the equity method … Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income ~~equity that have not been recognised in the investee's profit or loss~~. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised ~~directly in equity~~ in other comprehensive income of the investor (see IAS 1 Presentation of Financial Statements (as revised in 2007)).'*

5 *In addition, the amendments propose reclassification to profit or loss of the cumulative amount of equity that the investor previously recognised when the investor discontinues the use of the equity method.*

EFRAG's responses to the questions asked in the Exposure Draft

Question 1

The IASB proposes to amend IAS 28 so that an investor should recognise in the investor's equity its share of the changes in the net assets of the investee that are not recognised in profit or loss or OCI of the investee, and that are not distributions received. Do you agree? Why or why not?

Notes to EFRAG's Constituents

6 *EFRAG has not reached a consensus on whether it believes the proposed accounting – to require an investor to recognise directly in equity its ownership interest of the investee's other net asset changes – is appropriate. This Draft Comment Letter therefore sets out the views of EFRAG members and asks constituents for their comments.*

EFRAG's response

7 The views of EFRAG members can be summarised as follows:

(a) View 1: The investor should recognise directly in equity its ownership interest of the investee's other net asset changes (the approach taken in the ED);

(b) View 2: The investor should only recognise changes in the investee's net assets that arise from profit or loss, other comprehensive income (OCI) and distributions received; and

(c) View 3: The investor should account for the investee's other net asset changes that result in indirect decreases and increases in the investor's ownership interest, in the same way as actual disposals and acquisitions of interest in the investee (the recommendation from the IFRS Interpretations Committee).

View 1: The investor should recognise directly in equity its ownership interest of the investee's other net asset changes

8 Some EFRAG members agree with the proposed accounting to recognise in the investor's equity its share of other net asset changes.

9 Although these EFRAG members acknowledge that the proposed accounting would create an inconsistency with IAS 1 *Presentation of Financial Statements*, as it is explained in paragraphs 22-23, they share the views expressed in BC6 of the ED that the equity method of accounting under IAS 28 is understood to be a one-line consolidation; therefore, including the investor's ownership interest of the investee's other net asset changes in equity would be consistent with that view.

10 These EFRAG members also share the IASB's rationale explained in BC4 of the ED that other net asset changes of the investee result from transactions that are neither profit or loss nor OCI but, rather, they are investee's equity transactions. These members agree with the example in BC4 that notes that when an investee issues additional shares to third parties for cash, the investee records cash received and the corresponding equity, and that the transaction does not involve recognition of income and expenses. Therefore, it does not represent a performance of the investee.

View 2: The investor should only recognise changes in the investee's net assets that arise from profit or loss, other comprehensive income (OCI) and distributions received

11 These EFRAG members believe that the equity method is more akin to a valuation method, and therefore disagree with the view in BC6 of the ED that the equity method of accounting method is a one-line consolidation. On this basis, they believe that the investor should not account for other net asset changes in the

investee, because doing so could be inconsistent with the equity method. In their view, an investor should *only* recognise changes in the investee's net assets that arise from profit or loss, other comprehensive income (OCI) and distributions received; which are already required by IAS 28.

12 These EFRAG members note that an investee's other net asset changes are equity transactions that are unrelated to the investor and which should therefore not affect the investor's accounting under the equity method. Therefore, in their view, the recognition of other net asset changes by the investor would give a misleading representation of the investee's operations, since the investor is not a party in such 'equity' transactions.

13 Finally, in certain circumstances the pricing of the investee's equity transactions might be an indicator of impairment (e.g. if the investee issues or buys back shares at a price lower than its net asset value). In those cases, these EFRAG members would expect an investor to assess whether the entire investment in an associate or joint venture would need to be assessed for impairment according to IFRS.

View 3: The investor should account for the investee's other net asset changes in the same way as actual disposals and acquisitions of interest

14 Some other EFRAG members disagree with the proposed accounting for the following main reasons.

(a) It is inconsistent with concepts and principles in the existing IFRS literature.

(b) It would result in these other net asset changes (which result in a decrease (increase) in the investor's ownership interest in the investee), being accounted for differently from actual decreases and increases of ownership interest in an investee.

(c) It would not provide timely and useful information about the investor's performance.

15 These EFRAG members believe that a short-term solution should not introduce a conceptually new approach, without having a thorough debate about the conceptual issues related to the equity method of accounting, and should avoid creating inconsistencies with existing IFRS.

16 In the view of these EFRAG members, an investee's other net asset changes should be accounted for as deemed disposals and acquisitions; in the same way as actual disposals and acquisitions of interest in an investee. This view is in line with the tentative decision taken by the IFRS Interpretations Committee in its initial recommendation to the IASB, and largely in line with current practice, as documented in the IFRS manuals published by various audit firms.

17 The concerns and the preferred approach of these EFRAG members are explained in more detail below.

Application of the equity method of accounting under IAS 28

18 These EFRAG members note that central to the issue is the meaning of the equity method. As noted in paragraph BC6 of the ED, some believe that the equity method is a one-line consolidation, while others believe that it is more akin to a valuation approach. IAS 28 is not explicit on this issue.

19 IAS 28 describes the equity method as a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the net assets of the investee. Furthermore, an investee accounted for under IAS 28 is not part of a 'group' as defined in IFRS 10.

20 The EFRAG members supporting view 3 believe that the equity method should be seen as a basis of measurement (valuation approach). This view is further supported by paragraph BC24D of IAS 39 *Financial Instruments: Recognition and Measurement* which describes the equity method as an acquisition of a financial asset, and adds that the acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent net assets. Therefore it does not imply that the principles for business combinations and consolidations can be applied by analogy to the equity method.

21 Accordingly, these EFRAG members do not believe that all equity transactions of an investee (e.g. the acquisition of treasury shares) should necessarily be 'mirrored' in the investor's equity accounting for the investee as this presumes that there is no difference between the investee's and the investor's perspective.

Consistency with IAS 1

22 The approach proposed by the IASB would present certain transactions between an investee and third parties as if they were transactions with the investor's owners. These EFRAG members believe that this proposed approach would lead to an inconsistency with the presentation requirements in IAS 1 *Presentation of Financial Statements*, which requires an entity to present all owner changes in equity within a statement of changes in equity. Non-owner changes are presented in the statement of comprehensive income, and arguably the investee's other net asset changes should also be presented in the statement of comprehensive income.

23 Furthermore, the accounting proposed would change the nature of equity as described in IAS 1; not only would the investee's equity transactions be recognised as if they were transactions in the investor's equity, but also the equity transactions of indirect associates and ventures held through an investee would be 'rolled-up' into the investor's equity.

24 Although the IASB acknowledges the inconsistency with IAS 1, as explained in paragraph BC8 of the ED, it concluded that going back to the past requirements would be the most reasonable and expeditious approach to address diversity in practice. These EFRAG members disagree with this reasoning and note that the amendments made in 2007 stated that:

> '11 Under the equity method … Adjustments *to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's* other comprehensive income ~~equity that have not been recognised in the investee's profit or loss~~. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised ~~directly in equity~~ in other comprehensive income of the investor (see IAS 1 *Presentation of Financial Statements* (as revised in 2007)).'

25 In the view of these EFRAG members IAS 28 pre 2007 amendments did not require an investor to account for *all* types of other net asset changes in the investor's equity, and therefore the previous wording of IAS 28 might also have led to diversity in practice.

Accounting for decreases in the investor's ownership interest in the investee (deemed disposals)

26 Under the equity method, the investor recognises gains or losses arising from an actual disposal of an investee in its profit or loss.

27 These EFRAG members note that a decrease in the investor's ownership interest (i.e. decrease in percentage interest) in the investee might occur for different reasons, for example, the investor's decision not to participate in an investee's share issue would result in an indirect decrease in its ownership interest. However, from an economic perspective, they consider a decrease in an investor's ownership interest in an investee to be economically equivalent to a (actual) disposal of a portion of the investee, and should therefore be accounted for in the same way. In both cases, the investor's ownership interest in the investee decreases.

28 Recognising dilution gains or losses in profit or loss resulting from a deemed disposal, due to a decrease in the investor's ownership interest in the investee, would be consistent with the existing requirement in IAS 28 to reclassify into profit or loss part of the amounts recognised in OCI on a partial disposal, and would provide useful information on a timely basis.

29 These EFRAG members also note that, given that economically deemed disposals and actual disposals are largely equivalent (although tax and legal requirements have an impact), the proposed requirements might encourage entities to engage in structuring of transactions to obtain the desired accounting outcome.

Accounting for increases in the investor's ownership interest in the investee (deemed acquisitions)

30 Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost. IAS 28 is however silent on the accounting for any subsequent acquisition of additional investments in the same associate.

31 An increase in the investor's ownership interest in the investee (a deemed acquisition) might occur, for example, when the investee buys back share capital currently in issue from third parties by paying cash. In this example, the investor is indirectly acquiring shares from other shareholders although using the investee's cash to do so. In this case, the investor's ownership interest in the investee increases.

32 Similar to the rationale articulated above in relation to 'deemed disposals' of interest in an investee, EFRAG members supporting view 3 consider that indirect increases in the investor's ownership interest are economically similar to the purchase of an additional stake in the investee, and should be accounted for in the same way. Essentially this means that an investor should recognise a deemed acquisition at the fair value of the consideration paid, which may be nil.

Other transactions that may potentially increase or decrease the investor's ownership interest in the investee

33 An investee may enter into certain types of exchange transactions (e.g. share-based payments or writing call options) that have the potential to increase or decrease the investor's ownership interest (i.e. percentage interest) in the future, but that result in the receipt of consideration by the investee (e.g. services or cash) while not immediately affecting the investor's ownership interest (i.e. percentage held in the investee).

34 This raises the question whether the investor – in accounting for the effects of such an exchange transaction by the investee – should account for a share in the consideration received and whether or not it should ignore the potential future change in it percentage interest.

35 These EFRAG members believe that in developing an appropriate accounting solution for share-based payment transactions and transactions involving written options, the following factors could be considered by the IASB:

(a) Before an investor's ownership interest (i.e. percentage interest) effectively changes, an investor should only account for the other net asset changes in the investee that it owns and not for other elements that represent rights of other classes of equity instruments (e.g. preference shareholders or option holders).

(b) The overall effects of the transaction (i.e. the various legs of the transaction including any consideration received and the effects of exercise/lapse) should be reported in the same accounting period.

(c) If the transaction results in a deemed disposal or a deemed acquisition from the investor's perspective, those should be accounted for in the same way as actual disposals and acquisitions as explained in the paragraphs above.

36 For example, an investee writes a call option over its own shares and receives consideration of CU 10. If that transaction takes place at arm's length then, in their view, an investor who holds a 30% interest in the investee should not recognise a Day 1 gain in profit or loss, OCI or equity as this ignores the dilutive potential of the transaction. Instead, the investor should recognise the overall effect of the exchange transaction once the uncertainty is resolved (i.e. when the option is exercised or lapses).

37 These EFRAG members recognise that since, under the proposals, the amounts in the investor's profit or loss and its statement of equity would be offset once the investee is disposed of, the investor's profit or loss and its statement of equity for each reporting period would not portray the performance of that period.

Question to EFRAG's constituents

38 Which of the three views do you support? Please explain why.

39 Are there any additional arguments that have not been identified above?

Question 2

The IASB also proposes that an investor shall reclassify to profit or loss the cumulative amount of equity that the investor had previously recognised when the investor discontinues the use of the equity method. Do you agree? Why or why not?

EFRAG's response

Notes to EFRAG's Constituents

40 *EFRAG has not reached a consensus on whether it believes the proposed accounting – to require an investor to recognise directly in equity its ownership*

interest of the investee's other net asset changes – is appropriate. This question therefore sets out the views of EFRAG members and asks constituents for their comments.

EFRAG's response

EFRAG members that support View 1

41 As explained in the response to question 1, these EFRAG members agree with the IASB's proposal to require an investor to recognise directly in equity its ownership interest of the investee's other net asset changes.

42 These EFRAG members also agree with the proposal. In their view, recycling (reclassification) of the cumulative amount of equity that it had previously recognised in relation to the investee's other net asset changes, when an investor disposals of an investee, is consistent with paragraph 22 of IAS 28, which requires an investor to account for all amounts previously recognised in OCI in relation to an investment on the same basis as would have been required if the investee had directly disposed of the related assets or liabilities. This is further explained in BC10 of the ED.

EFRAG members that support View 2

43 As explained in the response to question 1, these EFRAG members believe that the equity method under IAS 28 should be seen as a valuation approach and concluded that the investor should not account for other net asset changes in the investee; therefore, recycling (reclassification) would not be needed under this view.

EFRAG members that support View 3

44 As indicated in the response to question 1, these EFRAG members believe that an investor should account for an investee's other net asset changes as deemed acquisitions and disposals when such changes result in indirect increases and increases in the investor's ownership interest.

45 Therefore, under this view, recycling would not be needed because any gains or losses would be reported in profit or loss in the period in which the net asset change occurs at the investee level. In the case of impairment, any loss would be immediately recognised in profit or loss.

46 These EFRAG members note that the IASB's proposal would not provide useful and meaningful information about the investor's performance on a timely basis. In addition, it would add complexity and it would fail to recognise in profit or loss on a timely basis impairments of the investee. In this respect, these EFRAG members note the following:

(a) The proposed amendments would require recycling for one type of item recognised directly within the investor's equity. This type of 'recycling' has not been required explicitly before in IFRS literature. Thus, treating equity as if it were OCI might result in added complexity and cause confusion about the distinction between OCI and equity.

(b) Under the proposed accounting, the carrying amount of the investment might be reduced with a corresponding debit to the investor's equity if changes in the investee's equity result in an overall loss for the investor. As a consequence, losses might be deferred in equity and would only be presented in profit or loss when the investor discontinues the use of the equity method.

Question to EFRAG's constituents

47 What are your views on the IASB's proposal on recycling (reclassification)?

48 Are there any additional arguments that have not been identified above?

Question 3

Do you have any other comments on the IASB's proposals?

EFRAG's response

49 EFRAG does not have any other comments on the proposals.