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28 March 2012

Dear Sir

Exposure Draft ED/2012/3 - Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28).

We are pleased to respond to the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

We agree that it would be appropriate to amend and clarify the requirements of IAS 28. However, we do not agree with the proposals or the rationale on which they are based. We are concerned at the implications of certain of the proposals, in particular the introduction of recycling of amounts from equity, and agree with points included in the Alternative View.

The Board appears to have based the proposals in the ED around the concept of equity accounting being a 'one line' consolidation. However, certain of its decisions in the past have been based on the concept of equity accounting being a measurement (valuation) approach, in particular the Annual Improvements to IFRS that were issued in May 2008 and dealt with the appropriate approach for the impairment of investments in associates.

In our view, equity accounting contains elements of both approaches, and this is reflected in IAS 28.26 which states that many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. However, this does not mean that it is appropriate for an investor in an associate to account for its investment in the same way as if it was a subsidiary. A fundamental difference is that a subsidiary forms part of an investor's consolidated group, while an associate does not. Consequently, while certain transactions involving subsidiaries are appropriately reflected in the parent's equity, this is because they involve transactions with owners in their capacity as such. Associates do not form part of an investor's consolidated group, and so it is not appropriate for transactions to be accounted for as if they were; it is also inconsistent with the requirements of IAS 1 *Presentation of Financial Statements* (as noted in paragraphs AV3 and AV4 of the Alternative View).

[1] Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels. Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.

We are particularly concerned that the proposals would result in:

- The recognition of amounts directly in equity when they involve transactions that are not with owners in their capacity as such
- Inconsistent treatment of direct and deemed changes in an investor's interest in an equity accounted investee
- The introduction of recycling of amounts from equity

We note that the Board has suggested, in paragraph BC8 of the Basis for Conclusions, that the proposed amendments would result in the requirements for equity accounting being returned to those that applied before revisions in 2007. While that may be the case (although the proposed amendments are more specific than the previous version of IAS 28), we do not believe that it would be appropriate to amend IAS 28 to be inconsistent with key principles of, and other requirements contained in, IFRS.

We have also considered the effect of applying the proposals, both on adoption which would involve retrospective application and in future. We are concerned that the proposals could give rise to practical difficulties on adoption, and increased complexity in future periods.

Our detailed comments, set out in the attached Appendix, include a suggested alternative approach for amendments to IAS 28. We believe that these would address the concerns that have been raised about diversity in practice under the current requirements of IAS 28, be consistent with other aspects of IFRS, and be more straightforward and practical to implement and apply in future.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300.

Yours faithfully,

Andrew Buchanan.

Andrew Buchanan

Global Head of IFRS

Appendix

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?

While we agree that it would be appropriate to amend and clarify the requirements of IAS 28, we do not agree that an investor's share of all changes in the net assets of an investee, that are not recognised in profit or loss or OCI of the investee, should be recognised in equity. Consequently, we disagree with the proposals.

The effect of the proposals would appear to result in equity accounting effectively being a one line consolidation, as noted in paragraphs BC6 and BC7 of the basis for conclusions. However, we do not believe that this is either an appropriate approach, or one that is supported by current IFRS literature.

We acknowledge that IAS 28.26 notes that:

> 'Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. Furthermore, 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 or a joint venture.'

However, this paragraph does not state that it is appropriate for *all* consolidation procedures to be applied for the purposes of the equity method, which implies that in some cases a different approach should be applied.

We also note that IAS 28.40 requires that, for the purposes of impairment losses, an investor in an associate applies the requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. This indicates that an investment in an associate is regarded as being a single asset, rather than a one line consolidation. This is supported by IAS 39.BC24D:

> '....The acquisition of an interest in an associate does not represent an acquisition of a business with the subsequent consolidation of the constituent net assets. 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......'

IAS 28.BC27, which was introduced as part of *Improvements to IFRS*, issued in May 2008, and is referred to in IAS 39.BC24D states that:

> '.....The Board decided that an investor should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associate because the investment is the only asset that the investor controls and recognises.'

Consequently, if the Board does decide to proceed with the proposals as drafted, we believe that there are consequential amendments that would be required elsewhere.

However, in our view, while it may be appropriate for certain consolidation procedures to be applied for the purposes of the mechanics of equity accounting, there are certain transactions that should be accounted for differently. Although we acknowledge that, prior to the revision in 2007, IAS 28.11 required that changes in investor's proportionate interest in the investee arising from changes in the investee's equity, that have not been recognised in the investee's profit or loss, to be recognised directly in equity, we do not believe that it is appropriate to revert to an approach which is conceptually flawed.

In particular, we note and agree with the Alternative View set out in paragraphs AV3 and AV4 of the ED, which highlights the inconsistency of the proposals with IAS 1 *Presentation of Financial Statements*. We agree with the analysis in paragraph AV11 that if, for example, an associate makes a successful capital increase in which the investor has not participated, the investor's share of that capital increase should be recognised in profit or loss.

We also note that the proposed IAS 28.25 would require the recycling of amounts from Other Comprehensive Income if an investor's ownership interest in an associate is reduced, but the investor continues to apply the equity method. In the case of a deemed disposal, this would appear to result in an outcome where the investor would recognise its share of the associate's equity transaction that gives rise to the deemed disposal in its own equity, but might be required to recognise an amount in profit or loss by recycling amounts from Other Comprehensive Income that result from the deemed disposal of the associated assets. We believe that this accounting is counter intuitive and flawed.

We note that the Board has covered the question of deemed acquisitions and disposals in paragraph BC4 of the Basis for Conclusions. While we agree that such a gain or loss would not reflect the performance of the investee, it does represent an economic gain or loss for the investor. Consequently it is appropriate for the investor to recognise this economic outcome in profit or loss. In order clearly to differentiate such gains and losses from other gains and losses arising from the application of the equity method they could be disclosed separately on the face of the Statement of Comprehensive Income as a component of the equity accounted gain or loss.

We also do not believe that it is appropriate for an investor in an associate that has granted an equity settled share-based payment to recognise a credit directly to equity. This again links to the inconsistency with IAS 1. We have considered whether it would be appropriate to include a the investor's share of the related charge in profit or loss, with a corresponding credit to Other Comprehensive Income, but have concluded that this would not be appropriate. This is because, if a deemed disposal of an investor's interest in an investee arising from the exercise of share options was properly accounted for in profit or loss, there is potential for the charge to be double counted (first as a share-based payment expense, and then again as a dilution loss).

However, we do not agree with the approach suggested in paragraph AV10 of the Alternative View, that nothing should be recognised in all cases. Instead, in the event that an associate issued any potentially dilutive instruments during a reporting period (whether in the form of an equity settled share-based payment, the issue of warrants to third party investors, or otherwise) this should be treated as an indicator of impairment for the purposes of paragraph 9 of IAS 36 *Impairment of Assets*. This would be before, and in addition to, the requirement in IAS 28.40 - 41 to apply IAS 39 for an investor to determine whether any additional impairment loss needs to be recognised in respect of its net investment in an associate or joint venture. This again demonstrates that equity accounting is, in certain respects, a form of valuation rather than a one line consolidation.

Our suggested approach could be achieved by amending the proposed subparagraphs to paragraph 10 as follows:

a) ...

b) ...

c) ...

d) The investor's share of the investee's net asset changes, other than through its share of the investee's profit or loss, other comprehensive income and transactions with other owners, and distributions received, is recognised in other comprehensive income. Examples of such changes include those arising from the investee's revaluation of property, plant and equipment and from foreign exchange translation differences.

e) A change in the investor's share of the investee's net assets arising from transactions with other owners that the investee records directly in equity (for example, when an investee issues additional shares to third parties or buys back shares from third parties) is recognised in profit or loss. Adjustments for a change in the investor's share of the investee's net assets arising from equity-settled share-based payments shall be recognised by the investor in the period in which the investee issues the related equity instruments. An investor's share of an investee's charge for equity settled share-based payments shall be excluded from equity accounting as these have no effect on the investee's net assets.

f) The issue by an investee of any potentially dilutive instruments (for example, the granting of equity settled share-based payments or the issue of warrants to third parties) gives rise to an indicator of impairment in accordance with paragraph 9 of IAS 36 *Impairment of Assets*.

Associated amendments would also be required to delete certain of the IASB's proposed amendments (such as paragraph 22(c)(ii), and the additional text at the end of paragraphs 23 and 25).

We note that our suggested subparagraph d) is aligned with the existing requirements of IAS 28.10, and that our suggested approach would bring fewer changes to existing practice than the Board's proposals. We also note that our suggested amendments also deal with the issue of equity-settled share-based payments that was not addressed by the IFRS Interpretations Committee.

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?

We disagree.

We object in particular to the proposal to introduce a requirement to recycle amounts from equity, and agree with the concerns expressed in paragraph AV8 of the Alternative View. We note that the recycling of amounts from equity is not required by any other part of IFRS, and believe that it is inappropriate to make such a fundamental change as part of a minor amendment to IAS 28.

We do not believe that there is conceptual merit in extending the concept of recycling outside items that have been recorded in Other Comprehensive Income, and note that the proposed approach would not only be inconsistent with previous conclusions (see IAS 28.BC28) but also the requirements of other IFRSs such as IAS 16.41, which permits (but does not require) a revaluation surplus in respect of an item of property, plant and equipment that is disposed of to be transferred directly to retained earnings. If the Board remains of the view that certain items arising from equity accounting should be recorded directly in equity, we suggest that instead of amounts being recycled, they are transferred directly to retained earnings.

However, we note that our suggested amendments to the ED (see our response to question 1 above) would result in items that the Board is proposing to require to be recorded in equity to instead be recorded in Other Comprehensive Income. In the event that this approach was followed, we suggest that the existing requirements of IAS 28 are retained.

Question 3

Do you have any other comments on the proposals?

1) **Retrospective application**

   We believe that significant practical difficulties could arise from the proposed requirement for fully retrospective application of the amendments, and that the cost involved is unlikely to give rise to associated benefits. This is because retrospective application will simply result in the reallocation of various components of an investor's equity (i.e. the prior period changes in the net assets of equity accounting investees will need to be split between profit and loss, other comprehensive income, and equity).

   We do appreciate that, although the reallocation will ultimately result in the same (opening) total equity figure, there could be an effect on profit or loss in future, due to the potential recycling of amounts to profit or loss. However, for entities with numerous equity accounted investees (which themselves may have subsidiaries, joint arrangements and/or associates) and/or equity accounted investees with frequent other net asset changes, this retrospective application is likely to be costly in terms of time and resource. We are sceptical that this would result in significant practical benefits for users of financial statements.

   Consequently, we encourage the IASB to consider allowing prospective application of the amendment, with a transitional requirement simply to 'true-up' the opening carrying value of equity accounted investees from their current carrying amount to the investor's share of the investee's net assets (subject to impairment). This could be recorded as an adjustment to retained earnings.

2) **Investments in complex equity accounted investees**

   The proposed amendments would be relatively straightforward to implement prospectively for interests in equity accounted investees with simple structures. However, equity accounted investees that are themselves complex groups may give rise to difficulties in applying the proposed amendments, due to the need to identify and track amounts that might be recycled from equity at future dates (in particular for deemed acquisitions and disposals that arise from movements in the share capital of an investee, or in the share capital of an entity in which the investee holds an interest).

   We believe that the suggested alternative approach that we have outlined in our response to question 1 above would deal with this issue.