March 21st, 2013

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

Dear Madam/Sir,

Exposure Draft ED/2012/3 - Equity Method - Share of Other Net Assets Changes (Proposed Amendments to IAS 28)

The Israel Accounting Standards Board is pleased to have this opportunity to comment on the IASB's Exposure Draft ED/2012/3 *Equity Method - Share of Other Net Assets Changes (Proposed Amendments to IAS 28)* published in November 2012.

Please find bellow our detailed comments:

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?

In our opinion, the IASB should reconsider the proposed amendment for the following reasons:

1. The IASB states in paragraph BC6 of the ED:

   "Furthermore, some IASB members noted that the application of the equity method is consistent with the view held by some interested parties that equity method accounting is a one-line consolidation and including the investor's share of the investee's equity transactions in profit or loss would be inconsistent with that view. Some IASB members also noted that paragraph 26 of IAS 28 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."

To our knowledge, the question whether the equity method is a one-line consolidation or a measurement method has not been concluded. The determination whether the equity method is a one-line consolidation or a measurement method is fundamental and has implications on the proposed accounting for other net assets changes of an investee. If the equity method is a one-line consolidation, changes in the equity of the investee should also be reflected in the equity of the investor. But, if the equity method is a measurement method, we believe it is inappropriate to reflect those changes in the investor's equity.

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 investee's net assets…". Although IAS 28 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", IAS 28 includes specific procedures for applying the equity method. Furthermore, paragraph BC24D of IAS 39 states that "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." Therefore, in our opinion the equity method is a measurement method rather than a one-line consolidation. Consequently, the investor's accounting should not necessarily mirror the investee's accounting.

2. Paragraph BC51 of IAS 1 states "All items of non-owner changes in equity meet the definitions of income and expenses in the *Framework*. The *Framework* does not define profit or loss, nor does it provide criteria for distinguishing the characteristics of items that should be included in profit or loss from those that should be excluded from profit or loss." Owners are defined in IAS 1.7 as "holders of instruments classified as equity." From the investee's perspective, other net assets changes are certainly transactions with owners. However, from the investor's perspective, those other net assets changes in the investee are **not** transactions with owners, because no transactions with the holders of equity instruments of the investor have taken place. Therefore, from the investor's perspective, other net assets changes in the

investee meet the definitions of income and expenses and should not be recognised directly in equity.

3. It is common knowledge that two transactions that have the same substance should have the same results (ie if the same transaction can be executed in two different legal forms, the accounting treatment for the transaction should be the same regardless of its legal form). The following transactions have the same substance but will result in different accounting treatment if the proposals will become final:

   (a) Reduction in an ownership interest as a result of a sale of the investee's shares and a reduction in an ownership interest as a result of a shares' issue to a third party by the investee. In our opinion, a reduction in an ownership interest in an investee as a result of a shares' issue to a third party is equivalent to a sale of part of the shares of the investee held by the investor. IAS 28 treats a reduction in an ownership interest as a partial disposal. IAS 28.25 states that "If an entity's ownership interest in an associate or a joint venture is reduced, but the entity continue to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be classified to profit or loss on the disposal of the related assets or liabilities.".

   IAS 21 also treats a reduction in an ownership interest as a partial disposal. IAS 21.48D states "A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation…".

   In our opinion, both a sale of part of the investment and a shares' issue to a third party are partial disposals from the investor's perspective and the accounting treatment for both should be same (see illustrative example A below).

   (b) An increase in an ownership interest as a result of an acquisition of additional investee's shares by the investor and an increase in an ownership interest as a result of the investee's acquisition of its own shares (see illustrative example B below).

   Our experience indicates that all of these transactions are very common.

Illustrative example A

Assume an investor owns 30 per cent (300 ordinary shares of 1,000 ordinary shares) of the issued shares of an investee since its establishment. The equity of the investee amounts to CU 1,000 on December 30th 2012. If the investor sells 100 shares for CU 150 (CU 1.5 per share), the investor's share in the investee's profits is reduced to 20% and the investor recognises a profit from disposal of CU 50 (150-100). Alternatively, if the investee issues 500 ordinary shares for CU 750 (CU 1.5 per share) to a third party, the investor's share in the investee's profits is also reduced to 20%. The investment after the shares' issue amounts to CU 350 [(1,000+750)*20%], ie an increase of CU 50 (350-300). According to the ED in the first case (sale of 100 ordinary shares) the investor would recognise a profit, while in the second case the investor would recognise the increase in equity. In our opinion, the amount of CU 50 should be recognised in profit or loss in both cases, since in both cases there was a partial disposal of the investment.

Illustrative example B

Assume an investor owns 30 per cent (300 ordinary shares of 1,000 ordinary shares) of the issued shares of an investee since its establishment. The equity of the investee amounts to CU 1,000 on December 30th 2012. If the investor acquires 100 additional shares for CU 150 (CU 1.5 per share), the investor's share in the investee is increased to 40% and the investor recognises an increase of CU 150 in the investment, with no change in its equity. Alternatively, if the investee acquires 250 own shares for CU 375 (CU 1.5 per share) from a third party, the investor's share in the investee' is also increased to 40%. The investment after the own shares' acquisition amounts to CU 250 [(1,000-375)*40%], ie a decrease of CU 50 (250-300). According to the ED in the first case (acquisition of 100 ordinary shares) the investor would have no impact on its equity, while in the second case the investor would recognise the decrease in the investment in equity. In our opinion, in both of these cases there should be no effect on equity.

4. The ED does not define "other net assets changes in the investee" nor does it include an exhaustive list of other net assets changes in the investee. The consequence of applying the proposed accounting treatment for certain changes in the net assets of the investee is inconsistent when:

   (a) the investee issues warrants to third parties (see example C below)

   (b) the investee grants its employees equity instruments (see example D below).

   Example C

   Assume an investor owns 30 per cent (300 ordinary shares of 1,000 ordinary shares) of the issued shares of an investee since its establishment. The equity of the investee amounts to CU 10,000 on December 30th 2012. The investee issues 500 warrants for no consideration on December 31st 2012. Each warrant is convertible into one ordinary share for CU 15. All of the warrants were exercised on December 31st 2013. The profit of the investee for the year ended December 31st 2013 amounts to CU 18,000.

   The investment on December 30th 2013, prior to the warrants' exercise amounted to CU 8,400 [(10,000+18,000)*30%] and the share of the investee in profit or loss amounted to CU 5,400. As a result of the warrants' exercise, the investor's share in the investee decreases from 30% to 20% (300/1,500). The investment after the warrants' exercise amounted to CU 7,100 [(10,000+18,000+7,500)*20%]. Therefore, a decrease of CU 1,300 should be recognised. According to the ED this decrease should be recognised in equity. However, from an economic perspective, this decrease offsets the share in the investee's profits recognised in excess since that share has not taken into account the potential share of the warrants' holders in the investee's profit. The recognition of this decrease in equity rather than in profit or loss does not reflect the economic substance of the change.

   Example D

   As a result of a share options' issue to employees, the investee recognises an increase in its equity over the vesting period. According to the ED the investor should account for this change in the investee's equity as an increase in the investment and a corresponding credit to equity. However, the investor has no share in those share options. Furthermore, in consolidated financial statements share options issued by a subsidiary to its employees would have been treated as non-controlling interests and including the investor's share in that increase in the investee's equity is inconsistent.

We appreciate the opportunity to provide our comments.

Sincerely,

Dov Sapir, CPA, Chairman
Israel Accounting Standards Board