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Mr Hans Hoogervorst
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Our ref JS/IASB-ED
Contact Mark Vaessen

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Dear Mr Hoogervorst

Comment letter on ED/2012/3 *Equity Method: Share of Other Net Asset Changes*

We appreciate the opportunity to comment on ED/2012/3 *Equity Method: Share of Other Net Asset Changes – Proposed amendments to IAS 28*. We have consulted with, and this letter represents the views of, the KPMG network.

We do not support the proposed amendments, which we believe are inappropriate from the point of view of both the conceptual framework and the broader substance of the transactions. Instead, in this letter we propose an alternative model that we believe should be considered by the Board.

Appendix 1 to this letter contains our responses to the specific questions raised in the ED, and Appendix 2 outlines our suggested alternative model.

Please contact Mark Vaessen or Julie Santoro at +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix 1

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?

We disagree with the proposed amendment.

We agree with the alternative view of Takatsugu Ochi that the proposed amendment is inconsistent with the concepts of other IFRSs. In explaining our objection to the proposal, we believe that there are two separate issues to address:

- Should an investor recognise its share of changes in the net assets of an investee that are not recognised in the profit or loss or other comprehensive income of the investee (other net asset changes)?
- If yes, then where should the investor record its share of those changes?

On the first question, a gain or loss would be recorded by an investor that had a direct reduction in stake (a dilution) in an equity-accounted investee. Similarly, an investor that increased its stake directly (a concentration) would record an increased investment. We see no reason why an investor that has an indirect dilution or concentration of its stake should not account for that transaction in the same way. Therefore, we agree that an investor should account for its share of other net asset changes.

On the second question, we do not agree that the effect of such changes should be recognised in equity, for the following reasons:

- In accordance with the definition in IFRS 10 *Consolidated Financial Statements*, a group comprises only the parent and its subsidiaries. From the point of view of the group, the transactions that are the subject of the ED are not with shareholders of the parent, and they are also not with shareholders who are non-controlling interests in the consolidated financial statements. Therefore, they are not equity transactions and we disagree with their characterisation as such in BC4, and the analogy made in BC6.

- The proposed amendment is also inconsistent with paragraph 4.25 of the Conceptual Framework. A credit meets the definition of income because it does not arise from contributions from equity participants; similarly, a debit meets the definition of expenses because it does not arise from distributions to equity participants. Such income or expenses are part of the performance of the investor (the results of its investing activities). Therefore, we disagree with the arguments presented in BC4.

- Looking at the substance of the transactions that are the subject of the ED, we see no reason for such transactions to be treated differently from transactions that occur directly between the investor and investee.

  – If an investor dilutes its interest through, for example, a sale of part of its interest to a third party, then it records a gain or loss. The same economic effect could be achieved by an indirect dilution in which the associate issues shares to a third party. We can see no reason why such an indirect dilution should be accounted for differently from a direct dilution (with gains or losses recorded in profit or loss). That treatment would be changed by the proposed amendments such that the indirect dilution gains or losses would be suspended in equity. We do not believe that such an outcome is appropriate.

  – Similarly, if an investor increased its stake directly by acquiring additional shares, then the cost thereof would be recorded as a debit to the cost of investment. We can see no basis for an indirect increase in stake being treated differently.

While we disagree with the proposed amendment, we do agree that the issue of other net asset changes should be resolved, and we understand the Board's desire for a generalised approach that does not introduce complexity (BC3). In Appendix 2 to this letter we outline an alternative model that we believe should be considered by the Board.

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 with the proposed amendment.

As noted in our response to Question 1, we disagree with the overall proposal for an investor to recognise its share of other net assets changes in equity. However, even if the Board proceeds with the amendment in its current form, we disagree with reclassification.

The Board's arguments for supporting recognition directly in equity are built on the idea that other net asset changes are equity transactions – i.e. transactions with shareholders in their capacity as shareholders. Therefore, there is no conceptual basis for a reclassification and no precedent in other IFRSs. Introducing reclassification would blur the boundaries between equity and OCI.

In addition, reclassification implies that other net assets changes are part of the investor's performance (with which we agree), but that the related gains and losses can be deferred. In that case, we can see no justification for deferral.

Question 3

Do you have any other comments on the proposals?

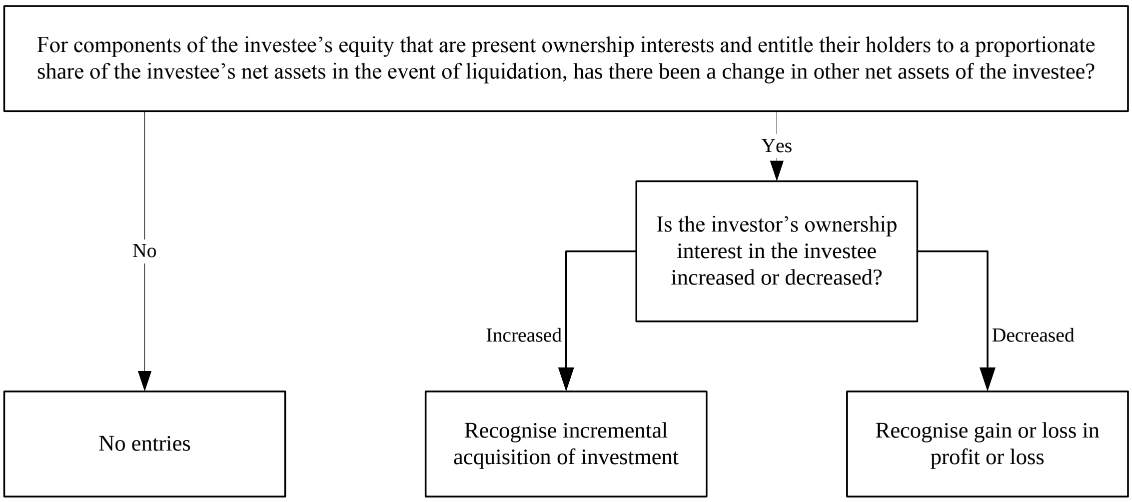
If the Board proceeds with the amendment in its current form, then we recommend prospective application (with early adoption permitted). Retrospective application would result in double counting. For example, for an investor who previously recognised its share of other net assets changes in profit or loss, that amount would be reclassified to equity on adoption of the ED and then would be reclassified to profit or loss again when equity accounting ceases. We believe that such double counting would not be appropriate.

In addition, prospective application would be consistent with the Board's other proposed limited scope amendments in ED/2012/6 *Sale or Contribution of Assets between an Investor and its Associates or Joint Venture* and ED/2012/7 *Acquisition of an Interest in a Joint Operation*.

Appendix 2

This Appendix outlines an alternative model of accounting for an investor's share of other net asset changes that we believe the Board should consider. This model takes the tentative proposal of the IFRS Interpretations Committee (BC2) and adds a further test.

The following is an overview of the model, whose starting point is that there has been a change in other net assets of the investee.



The initial question uses the same principles as paragraph 19 of IFRS 3 *Business Combinations* in distinguishing between 'ordinary' and 'other' non-controlling interests, as a mechanism for identifying whether there has been a change in the interests of the investor; the underlying assumption is that the investor's interest is in ordinary equity.

- If the answer to this question is 'no', then no entries would be made because the underlying transaction did not involve ordinary equity.

- If the answer to this question is 'yes', then the next question would be whether the investor's ownership interest has increased or decreased.

  – If it has increased, then the investor would recognise the incremental cost of its investment. In the transactions that are the subject of these amendments, that cost would be zero – i.e. no entry would be recorded.

  – If it has decreased, then the investor would recognise a dilution gain or loss.

Subsequent to the accounting for the transaction, the investor would continue to apply equity accounting based on its share of the investee's profit or loss, which may or may not be changed as a result of the transaction.

The following examples illustrate how the model works (headings are a shortcut of the questions in the above flowchart).

Scenario	Change in interests?	Increase or decrease?	Outcome	Footnote
Investee issues ordinary shares to a third party for cash	Yes	Decrease	Gain / loss in profit or loss	1, 8
Investee buys back its ordinary shares from other shareholders	Yes	Increase	Incremental acquisition of investment	2, 8
Investee buys additional ordinary shares in its subsidiary from its non-controlling interests	Yes	Increase	Incremental acquisition of investment	3
Investee accounts for an equity-settled share-based payment transaction – date of issue (unvested)	No	N/A	No entries	4
Investee accounts for an equity-settled share-based payment transaction – date of exercise	Yes	Decrease	Gain / loss in profit or loss	5, 8
Investee issues a warrant for cash	No	N/A	No entries	6
Warrant issued by the investee lapses unexercised	Yes	Increase	Incremental acquisition of investment	7

Footnotes:

1. The investor suffers a dilution in its ownership interests.
2. The investor has a concentration in its ownership interests.
3. Although the investor's percentage ownership does not change, there has been a change in the investee's equity attributable to ordinary shareholders.
4. The *investee* will recognise an entry to debit profit or loss and credit equity. The debit entry will be picked up by the *investor* in its equity accounting, with a corresponding credit to the carrying amount of the investment.

   Although the investee has recognised a credit to equity, there has been no change in the investee's equity attributable to ordinary shareholders. Therefore, no additional entries are recorded.
5. At the date of exercise, the investor suffers a dilution in its ownership interests.
6. Although the investee has recognised a credit to equity, there has been no change in the investee's equity attributable to ordinary shareholders.

7. Assuming that the warrant was issued for a premium, if the warrant lapses unexercised, then the investor's percentage ownership does not change; however, the investee's equity attributable to ordinary shareholders has changed.
8. As a result of each of these transactions, the investor's percentage ownership in the investee has changed. Therefore, subsequent to its accounting for the transaction, the investor will account for its share of the investee's profit or loss on the basis of its new interest.