ASC
ACCOUNTING STANDARDS COUNCIL

22 March 2013

International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
United Kingdom

(By online submission)

Dear Sirs

RESPONSE TO EXPOSURE DRAFT ON EQUITY METHOD: SHARE OF OTHER NET ASSET CHANGES

The Singapore Accounting Standards Council appreciates the opportunity to comment on the Exposure Draft on Equity Method: Share of Other Net Asset Changes (the ED) issued by the International Accounting Standards Board (the Board or IASB) in November 2012.

General

We agree that IAS 28 *Investments in Associates and Joint Ventures* lacks clarity insofar as the application of the equity method on an investee's other net asset changes is concerned (the "other net asset changes issue") and appreciate the Board's desire to address observed practice diversity in the short-term expeditiously.

However, we have a number of concerns with the Board's proposed short-term solution, as elaborated in our comments on the specific questions in the ED below. In our view, the challenge in addressing the other net asset changes issue stemmed from the very fact that equity method, in itself, lacks clarity and is inherently conflicting. We are therefore not supportive of the Board's overly simplistic approach to dealing with conceptual issues, by prescribing seemingly simple but conceptually indefensible and inconsistent short-term solution to address practice diversity.

Short of a holistic and fundamental review of the equity method, we believe that it is virtually impossible to develop a short-term solution that is principles-based and conceptually aligned with existing IFRSs requirements, without being unduly complex. As such, we urge the Board not to introduce any short-term amendments to IAS 28, but rather, to devote resources to the priority research project on equity method, which the Board had added to its research agenda following the conclusion of its three-yearly agenda consultation, with the aim of developing conceptually sound accounting method and measurement basis for interests in associates and joint ventures.

In addition, we note that the other net asset changes issue has been in existence for several years and practice has developed over time, with guidance published by the major international accounting firms on some of the specific application issues. Furthermore, IAS 1 *Presentation of Financial Statements* requires disclosures of significant accounting policies and judgements made in applying them. Accordingly, we believe there is no pressing need for making short-term limited-scope amendments to IAS 28 at this point in time.

Our comments on the specific questions in the ED are as follows:

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 other comprehensive income (OCI) of the investee, and that are not distributions received. Do you agree? Why or why not?

We disagree with the proposed amendment as we are concerned that it lacks conceptual merits and creates inconsistencies with existing IFRSs requirements. Our specific concerns are set out below:

(i) Inconsistency with IAS 1 principles – Under IAS 1, only equity transactions of the group are recognised in equity in the consolidated financial statements, while all non-owner transactions must be recognised in either profit or loss or OCI. Since the investee's other net asset changes are non-owner transactions of the investor group, recognising these transactions in the investor's equity as proposed under the ED would contradict the principles of IAS 1.

(ii) Incompatible accounting outcome with economically similar transactions under IAS 28 – IAS 28 requires the gain or loss on reduction of interest in an investee arising from an actual disposal by an investor to be recognised in profit or loss. In contrast, the ED proposes that an investor recognise in equity, the gain or loss on reduction of interest in an investee arising from the investee's issuance of new shares to other shareholders (i.e. a deemed disposal). The ED proposal would therefore result in economically similar transactions being accounted for differently under IAS 28, which in our view is conceptually flawed. In this regard, we observe that there appears to be a broad consensus amongst guidance materials published by the major international accounting firms that deemed disposals should be accounted for in the same manner as actual disposals. This view is also shared by the IFRS Interpretations Committee as articulated in paragraph BC2 of the ED's Basis for Conclusions.

(iii) Cross-cutting issue with IAS 21 *The Effects of Changes in Foreign Exchange Rates* – IAS 21 requires an investor to reclassify to profit or loss, a proportionate share of exchange differences previously recognised in OCI, when there is any reduction in ownership interest in a foreign operation other than a subsidiary. Accordingly, when an investee issues new shares to other shareholders, the investor would recognise a portion of previously recognised exchange differences in profit or loss as prescribed by IAS 21, and the gain or loss on reduction of interest in equity as proposed under the ED. This means that elements of gain or loss on a single transaction would be recognised in profit or loss in different periods, which is conceptually difficult to appreciate.

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(iv) Conceptual challenges with one-line consolidation view – We note that the Board had rationalised the proposed amendment as being consistent with viewing equity method as a one-line consolidation. However, we observe that such a view appears at odds with the Board's more recent decisions on the accounting for loss of control and reduction in ownership interests when control or significant influence is retained

For example, when a subsidiary becomes an associate, any retained interest is remeasured at fair value through profit or loss. In contrast, when equity method continues to apply after a joint venture becomes an associate, IAS 28 prohibits remeasurement of retained interest because there is neither a change in group boundaries nor measurement requirements.

In the case of a reduction in ownership interests in subsidiaries, the parent would re-attribute a proportionate amount of the exchange differences previously recognised in OCI to non-controlling interests. Conversely, when ownership interests in associates are reduced, the investor would reclassify the equivalent amount to profit or loss instead.

We further observe that the one-line consolidation view is also inconsistent with the Board's comments in paragraph BC24D of the Basis for Conclusions on IAS 39 *Financial Instruments: Recognition and Measurement* as elaborated further below.

(v) Inconsistent with viewing interests in associates and joint ventures as financial instruments – If equity method is a measurement basis for financial instruments, we note that existing IFRSs would prohibit the investor from recognising in equity, changes in the carrying amount of equity-accounted investees, including those that relate to other net asset changes of the investees.

We note that the key challenge in addressing the other net asset changes issue stemmed from the very fact that equity method, in itself, lacks clarity and is inherently conflicting. At the conceptual level, it is unclear whether equity method is intended to be an "accounting method" that is akin to a one-line consolidation (i.e. how the financial position and performance of the investee is incorporated into the investor's financial statements) or a "measurement basis" for a particular type of financial instruments (i.e. how interest in the investee is measured in the investor's financial statements).

For example, 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 *Consolidated Financial Statements*". In contrast, paragraph 24D of the Basis for Conclusions on IAS 39 states that "an acquisition of an interest in an associate represents the acquisition of a financial instrument... paragraph 26 of IAS 28 explains only the methodology used to account for investments in associates... should not be taken to imply that the principles for consolidations can be applied by analogy to accounting for associates". Moreover, the requirements in IAS 28 on accounting for partial disposals (i.e. gain or loss is recognised in profit or loss) and impairment loss (i.e. impairment loss on the investment is not allocated to the investee's underlying assets, including goodwill) provide further support that equity-accounted investees are more akin to financial instruments.

As an accounting method, the concept that an associate or a joint venture is not part of the group would necessarily mean that "mirror" accounting between the investor and the investee is not always achieved. The requirement for the investor to recognise its share of all post-acquisition changes in the investee's net assets therefore raises questions/concerns over how some of these changes should be accounted for by the investor. This problem was aggravated by the revised IAS 1 that distinguishes owner transactions from non-owner transactions.

As a measurement basis, the cost-accumulation model is a hybrid measure that is neither cost nor fair value. Since equity method is not a fair value measurement, it is debatable whether a "loss" should be recognised for a reduction in the share of an investee's net assets that is not represented by impairment loss, or a "gain" for an increase in the investee's net assets that is not attributable to the investor.

For example, when the investee reacquires its shares from other shareholders at fair value, the investor's share of the investee's net assets would generally decrease, despite higher ownership interest. The "loss" represents the investor's share of other shareholders' interests in the investee's unrecognised fair value uplift. Recognising this "loss" appears counter-intuitive when the value of the investor's interest in the investee has in fact increased due to the unrecognised fair value uplift.

In another example, the investee issues warrants to other investors and the increase in net assets would not be attributable to the investor. In fact, the investor could potentially incur a loss on dilution of interest when the warrants are exercised, typically at a discount. In such cases, the investor is required to apply the equity method based on present ownership interest and recognise all changes in the investee's net assets, but recognising a corresponding "gain" would be counter-intuitive.

In view of the above broader issues with equity method, we do not support the Board's overly simplistic approach to dealing with conceptual issues, by prescribing seemingly simple but conceptually indefensible and inconsistent short-term solution to address practice diversity. Short of a holistic and fundamental review of the equity method, we believe that it is virtually impossible to develop a short-term solution that is principles-based and conceptually aligned with existing requirements in IFRSs, without being unduly complex.

In addition, we question the urgency of making short-term limited-scope amendments to IAS 28 at this juncture given that the other net asset changes issue has been in existence for several years now. Furthermore, practice has developed over time and the major international accounting firms have published guidance on accounting for some of the common types of investee's other net asset changes. In any case, IAS 1 requires disclosures of significant accounting policies, including those that are not specifically required by IFRSs but the entity selects and applies in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, as well as judgements that were made in applying the accounting policies or that have a significant effect on the amounts recognised in the financial statements.

Balancing between the desire to address practice diversity and the need to prescribe conceptually sound principles-based accounting, we urge the Board not to introduce any

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short-term amendments to IAS 28, but rather, to devote resources to the priority research project on equity method.

Notwithstanding the above, if the Board decides to proceed with making limited amendments to IAS 28 to address practice diversity, we would reluctantly accept an alternative of recognising in OCI share of investee's other net asset changes by the investor as an interim solution, provided that consequential amendments are made to IAS 21 to address the aforementioned cross-cutting issue and subject to our comments on Question 2 and Question 3.

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 proposal as it is inconsistent with existing IFRSs requirements as elaborated below:

(i) Inconsistency with existing IFRSs requirements for accounting for share of investee's OCI

(a) *Reduction in ownership interest* – Paragraph 25 of IAS 28 requires the investor to reclassify to profit or loss the proportion of the previously recognised share of the investee's OCI relating to the reduction in ownership interest. However, the investor is prohibited, under the ED, from reclassifying amounts recognised in equity for its share of the investee's other net asset changes in the same situation.

(b) *Discontinuation of equity method* – Paragraph 22 of IAS 28 requires the investor to account for previously recognised share of the investee's OCI on the same basis as if the investee had directly disposed of the assets or liabilities. In contrast, the investor is required to reclassify to profit or loss previously recognised share of the investee's other net asset changes even though the investee is prohibited from reclassifying these changes to profit or loss.

We do not believe that there are conceptual grounds to warrant the aforementioned accounting treatment differences.

(ii) Inconsistency with existing IFRSs principles on equity transactions – We note that existing IFRSs prohibit the reclassification of previously recognised equity to profit or loss, to be consistent with the principle that owner transactions should only be recognised in equity and not in profit or loss. The ED proposal would create a new class of "recyclable equity", which adds further confusion to the already confusing and conflicting OCI recycling requirements that the Board has yet to address.

Subject to our comments on Question 1, we can reluctantly accept reclassification to profit or loss, provided that the investor had previously recognise in OCI its share of the investee's other net asset changes. Specifically, the amount previously recognised in OCI would be reclassified to profit or loss in its entirety when equity method is discontinued, or proportionately when there is partial disposal and equity method continues to apply. Such a reclassification could be rationalised by IAS 28 requirement to recognise gains or losses on discontinuation of equity method and partial disposals in profit or loss, and as being broadly consistent with existing IFRS requirements.

Question 3

Do you have any other comments on the proposals?

Subject to our comments on Question 1 above, we disagree with the retrospective application requirement proposed by the ED. Since the proposed accounting conflicts with existing requirements and is generally different from current practice, retrospective application would cause undue burden, particularly if the accounting is likely to be changed yet again once the equity method research project is completed. The burden is especially acute for investors that have investees with frequent equity transactions and more complex group structures.

We hope that our comments will contribute to the Board's deliberation on the ED. Should you require any further clarification, please contact the project manager Siok Mun LEONG at leong_siok_mun@asc.gov.sg.

Yours faithfully

Suat Cheng GOH
Technical Director
Singapore Accounting Standards Council

Address: The Secretariat, Accounting Standards Council,
c/o Ministry of Finance, 100 High Street, #10-01, The Treasury, Singapore 179434.
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