Project **Annual Improvements—2010-2012 cycle**

Topic **IAS 28 *Investment in Associates*— equity method**

Introduction

1. In March 2011 the IFRS Interpretations Committee (the Committee) received a request to correct an unintended inconsistency between the requirements of paragraphs 2 and 11 of IAS 28 *Investment in Associates* and IAS 1 *Presentation of Financial Statements* (revised 2007) regarding the description and application of the equity method. The submitter asserts that this inconsistency arose when IAS 1 made a consequential amendment to IAS 28.11 as part of the 2007 revision to IAS 1.

2. The submission recommends an improvement to the wording of IAS 28.11 and requests that the Board should address this issue as part of the Annual Improvements project (AIP). The submission is reproduced in full in Appendix B to this paper.

Purpose of this paper

3. This paper:
   (a) provides background information on the issue;
   (b) includes the staff analysis and recommendation to add this issue as part of the annual improvements project; and
   (c) asks the Committee whether they agree with the staff recommendation.

Background information

Relevant literature (IAS 1)

4. In September 2007, the Board issued IAS 1 *Presentation of Financial Statements* (revised 2007) with the main objective being to separate changes in equity (net assets) of an entity during a period arising from transactions with owners in their capacity as owners from other changes in equity.

5. Paragraphs IN2 and IN 6 of IAS 1 set out this objective as one of the main features of the revised version of IAS 1 (revised 2007) (emphasis added):

> IN 2 The main objective of the International Accounting Standards Board in revising IAS 1 was to aggregate information in the financial statements on the basis of shared characteristics. **With this in mind, the Board considered it useful to separate changes in equity (net assets) of an entity during a period arising from transactions with owners in their capacity as owners from other changes in equity. Consequently, the Board decided that all owner changes in equity should be presented in the statement of changes in equity, separately from non-owner changes in equity.**
>
> IN 6 IAS 1 requires an entity **to present, in a statement of changes in equity, all owner changes in equity.** All non-owner changes in equity (ie comprehensive income) are required to be presented in one **statement of comprehensive income** or in two statements (a separate income statement and a statement of comprehensive income). **Components of comprehensive income are not permitted to be presented in the statement of changes in equity.**

6. As a consequence of separating changes in equity (net assets) with owners in their capacity as owners from other changes in equity, the Board also introduced, in paragraph 7 of IAS 1, definitions of *total comprehensive income* and *other comprehensive income* (OCI), which are shown below:

   (a) *total comprehensive income* is described as (emphasis added):

   > 'the change in equity during a period resulting from transactions and other events, **other than those changes resulting from transactions with owners in their capacity as owners**'

   (b) *other comprehensive income* is described as (emphasis added):

> '[it] comprises items of income and expense (including reclassification adjustments) **that are not recognised in profit or loss as required or permitted by other IFRSs'**

Relevant literature (IAS 28)

7. The consequential amendments to IAS 28 as a result of the revision to IAS 1 in 2007 are shown below (amendments have been struck through and underlined for ease of reference and emphasis has been added):

> 11 Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. **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 ~~equity~~ other comprehensive income.** 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 in ~~equity~~ other comprehensive income of the investor** (see IAS 1 Presentation of Financial Statements (as revised in 2007)).

8. Consequently, in the description of the equity method in paragraph 11:

   (a) the reference to 'changes in the investee's **equity** that have not been recognised in the investee's profit or loss' was replaced by: 'changes in the investee's **other comprehensive income**; and

   (b) the reference to 'The investor's share of those changes is recognised directly in equity of the investor' was replaced by: 'The investor's share of those changes is recognised directly **in other comprehensive income** of the investor'.

The issue submitted

9. The definition of equity method in paragraph 2 of IAS 28 indicates that <u>all</u> changes in the net assets of an investee should be recognised by the investor. However, the submission notes that IAS 28.11 specifies the accounting of the investor's share of profit or loss, distributions and other comprehensive income but is silent on the accounting for other changes in the investee's net assets when the investor applies the equity method. This is because paragraph 11 no longer states **whether** and **where** the investor should account for its share in those changes. Such changes might include:

    (i) movements in other reserves of the associate (eg share-based payment reserves);

    (ii) gains and losses arising on an associate's transactions with non-controlling interest of its subsidiaries; and

    (iii) liabilities recognised in respect of put options to non-controlling interests.

10. The submitter discusses four possible views on how to account for the investor's share in the changes in the investee's net assets that are not part of the investee's profit or loss, other comprehensive income and that do not represent distributions (hereafter referred to as 'investee's other changes in net assets'). The alternative views presented by the submitter proposed recognition in:

    (a) equity; or

    (b) OCI; or

    (c) profit or loss; or,

    (d) not at all (ie, do not recognise the transaction).

11. The submitter **rejects view a).** According to IAS 1, changes in equity arising from transactions with owners in their capacity as owners are to be presented separately from non-owner changes in equity. However, the investee's other changes in net assets would not be regarded as transactions with owners from an

investor's perspective, because 'an associate is not part of a [consolidated] group as defined in IAS 27 [*Consolidated and Separate Financial Statements*].

12. The submitter **rejects view b)** because the investor's share in the investee's other changes in net assets is not an OCI item in accordance with the definition of OCI (shown in paragraph 6 of this paper) or with the list of OCI items in IAS 1.7.

13. The submitter also **rejects view d)** because not recognising the investor's share in the investee's other changes in net assets is incompatible with the definition of IAS 28.2, whereby the cost of the investment is adjusted by all post-acquisition changes in the investor's share of the net assets of the investee.

14. The submitter **supports view c).** That is, the submitter supports the recognition in the **investor's profit or loss** of 'all other transactions of the investee that adjust the net assets of the investee without adjusting the investor's proportionate share in the net assets'. The submitter supports this view because it would eliminate any conflict with the guidance in IAS 1 that establishes the segregation of all owner and non-owner changes in the financial statements (as noted in paragraph 4 of this paper).

Staff analysis

<u>Whether</u> the investor should account for <u>all</u> changes in the associate's net assets

15. We agree that the current wording in paragraph 11 in IAS 28 is reflecting only part of the mechanics of the equity method. That is, it is only referring to the recognition of the investor's share in the associate's profit or loss, other comprehensive income and distributions and is omitting all the investee's other changes in net assets that should be recognised by the investor under the definition of the equity method in paragraph 2. We think that this omission in paragraph 11 is the product of an unintended oversight that needs to be corrected.

16. We agree that all components of the change in the investor's share of the investee's net assets should be recognised in accordance with the definition of equity method. We therefore agree that view (d) to the submission should be rejected.

17. We therefore think that paragraph 11 should be amended to explicitly refer to the investor's recognition of all changes in the net assets of the investee to be consistent with the definition of equity method in IAS 28.2.

Where ***the investor should account for all changes in the associate's net assets***

In equity?

18. The submitter considered the possibility that the investee's other changes in net assets could be recognised within the investor's owner changes in equity. However, IAS 1 precludes the investee's other changes in net assets from being regarded as 'owners' transactions' from an investor's perspective, because an associate is not part of the consolidated group as defined in IAS 27 *Consolidated and Separate Financial Statements*. The transactions with the associate's equity owners are not transactions with the group's equity owners.

19. We observe that before the consequential amendments derived from the revisions to IAS 1, paragraph 11 in IAS 28 referred only to the investor's share of the changes in the investee's equity. This was because the notion of OCI was not yet introduced by IAS 1, thus there was no need to split the investor's share in the investee's changes in equity into the investor's share in the investee's OCI and into the investor's share in the investee's other changes in net assets. After the amendment derived from the revision to IAS 1, that distinction between the investor's share in profit or loss, OCI and other changes in net assets was needed; however, IAS 28.11 was amended to refer only to the recognition of the:

    (a) the investor's share of the investee's profit or loss in the investor's profit or loss (as mandated by IAS 1.82(c))

(b) the investor's share of the investee's other comprehensive income in the investor's other comprehensive income (as mandated by IAS 1.82(h)).

20. We agree with the submitter that the split between owner and non-owner changes mandated by IAS 1 (revised 2007) and the definition of what should be included within changes in equity compared with profit or loss or OCI, precludes these other changes in net assets from being recognised within the investor's owner changes in equity. Consequently, we think that those changes should be recognised as part of the investor's non-owner changes in equity (total comprehensive income); that is, as either part of the investor's profit or loss or OCI.

In profit or loss or in other comprehensive income?

21. We have identified the following views for the recognition of the investor's share of the investee's other changes in net assets:

(a) **View A:** recognise this share in **profit or loss**, as everything must be recognised in profit or loss unless an IFRS requires or permits its recognition in OCI (in accordance with the definition of OCI in paragraph 7 of IAS 1).

(b) **View B:** recognise this share in **other comprehensive income** as:

(i) there was no indication when revisiting IAS 1 that the Board intended to modify the accounting of the investor's share in the associate's OCI and the other changes in equity when applying equity accounting; and

(ii) the list of OCI items in IAS 1 is not exhaustive and could potentially include the investor's share in the associate's other changes in equity; and

(iii) OCI is defined in IAS 1 as the residual change in net assets: changes that are non-owner changes that are not included in profit or loss.

Recognise in profit or loss

22. We do not agree that the investor's share of the investee's other changes in net assets should be recognised as part of the investor's share in the profit or loss of the associate. This is because the investor should reflect in its profit or loss, its share in the profit or loss of the associate as required by IAS 28.11 and by IAS 1.82(c).

Recognise in other comprehensive income

23. We think that the list of OCI components in IAS 1 is not exhaustive. In our view, other comprehensive income is defined on a residual basis as being items of income and expense that are not recognised in profit or loss within the statement of comprehensive income.

24. In addition, we could not find any evidence that the Board intended to change equity accounting for OCI and other changes in equity from the investor's perspective when the Board revised IAS 1.

25. Consequently, we think that the investee's other changes in net assets should be recognised within the investor's OCI.

Presentation within other comprehensive income

26. We think that the investor's share in other changes in the net assets of the associate could be presented within the statement of comprehensive income as part of the line item described in IAS 1.82(h). That is, as part of the investor's 'share of the other comprehensive income of associates and joint ventures accounted for using the equity method'.

27. However, we think that if the item is material enough in accordance with paragraph 86 of IAS 1, it should be disclosed separately in the statement of comprehensive income and could be referred to as: 'share of the other changes in the net assets of the investee'.

Staff recommendation

28. Based on the analysis provided above we recommend that:

(a) IAS 28.11 should be made consistent with the definition of equity method in IAS 28.2 to explicitly refer to adjustments to the carrying amount of an investment in associate arising from all changes in the investee's net assets. These changes will include the investor's share in:

   (i) the investee's profit or loss

   (ii) the investee's OCI

   (iii) the investee's other changes in net assets.

(b) the investor's share in the investee's other changes in net assets be recognised as part of the investor's non-owner changes in equity within the investor's OCI

(c) the investor's share in the investee's other changes in net assets be presented as part of the investor's 'share of the other comprehensive income of associates and joint ventures accounted for using the equity method' in accordance with IAS 82(h).

29. The proposed changes to paragraph 11 are presented in **Appendix A** of this paper.

Assessment against the new annual improvements criteria

30. We have assessed the proposed amendment to paragraph 11 against the enhanced annual improvements criteria, which are reproduced in full below:

> In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against the following criteria. All criteria (a)–(d) must be met to qualify for inclusion in annual improvements.
>
> (a) The proposed amendment has one or both of the following characteristics:
>
> (i) clarifying–the proposed amendment would improve IFRSs by:
>
> - clarifying unclear wording in existing IFRSs, or
> - providing guidance where an absence of guidance is causing concern.

A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

(ii) correcting–the proposed amendment would improve IFRSs by:

- resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or.

- addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.

A correcting amendment does not propose a new principle or a change to an existing principle.

[Staff analysis—this criterion is satisfied. There is a need to correct the mechanics of the equity method in paragraph 11. We also note that this proposed amendment will improve IFRSs by addressing an oversight arising from the revisions to IAS 1 in 2007.]

(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.

[Staff analysis—this criterion is satisfied. The issue is sufficiently narrow to ensure that the proposed change has been considered sufficiently and identified.]

(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach a conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

[Staff analysis—this criterion is satisfied. We think that the Committee will be able to address these issues on a timely basis and think that the Board should be in a position to also reach a conclusion on a timely basis. The issue can be sufficiently tackled by correcting the current wording in IAS 28.11, which will provide increased clarity where diversity currently exists, while not significantly affecting the primary accounting treatment that exists in practice for this issue.]

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.

[Staff analysis—this criterion is satisfied. Even though there is a current project to issue a revised version of IAS 28 Investments in Associates *as part of the Joint Arrangements project, this project is not contemplating any modifications to paragraph 11 of IAS 28]*

Staff conclusion

31. On the basis of the assessment under the existing annual improvements criteria, we think that the Committee should recommend to the Board that the change proposed to paragraph 11 in IAS 28 (refer to Appendix A of this paper) should be included in the **2010-2012 annual improvements** cycle.

Question to the Interpretations Committee

Question —proposed changes to paragraph 11 in IAS 28
Does the Committee agree with the staff recommendation in paragraph 28 and the proposed changes in Appendix A?

Appendix A – Proposed changes

A1. The proposed amendment to paragraph 11 is presented below.

Amendment to IAS 28 *Investments in Associates*

Paragraph 11 is amended (new text is underlined and deleted text is struck through).

Equity method

11 Under the equity method, the investment in an associate is initially recognised at cost at the date of acquisition. ~~and t~~ After the date of acquisition the carrying amount of the investment is increased or decreased to recognise:

(a) the investor's share of the profit or loss of the investee. ~~after the date of acquisition.~~ The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss.

(b) ~~D~~distributions received from an investee which reduce the carrying amount of the investment.

(c) the investor's share ~~Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising~~ of changes in the investee's other comprehensive income. 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 in other comprehensive income of the investor (see IAS 1 Presentation of Financial Statements (as revised in 2007)).

(d) the investor's share of the investee's other changes in net assets. The investor's share of those other changes is recognised in other comprehensive income of the investor.

A2. We are proposing adding the following paragraph to the Basis for Conclusions of IAS 28:

Basis for Conclusions on proposed amendments to IAS 28 *Investments in Associates*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Equity method

BC1 The Board received a request to correct an unintended inconsistency between the requirements of paragraphs 2 and 11 of IAS 28 *Investment in Associates* and IAS 1 *Presentation of Financial Statements* (revised 2007) regarding the description and application of the equity method. This inconsistency arose when IAS 1 made a consequential amendment to paragraph 11 of IAS 28 as part of the 2007 revision to IAS 1. The Board proposes a modification to paragraph 11 of IAS 28. The proposed amendment clarifies that the investor should recognise as part of its share all changes in the investee's net assets. The proposed amendment also clarifies that other changes in the investee's net assets that are not the investor's share of the investee's profit or loss or other comprehensive income or distributions received, shall be recognised as part of the investor's non-owner changes in equity within the investor's other comprehensive income.

Appendix B – Request for Annual Improvements

B1 The staff received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

REQUEST FOR ANNUAL IMPROVEMENTS

The issue:

The revisions to IAS 28 *Investments in Associates* paragraph 11 and IAS 1 *Presentation of Financial Statements* have given rise to a contradiction with the definition of equity accounting in IAS 28 paragraph 2 by narrowing the changes in the net assets of the associate that may be recognised by the investor.

IAS 28.2 defines 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 net assets of the investee.

This definition indicates that all changes in the net assets of the associate should be recognised by the investor.

IAS 1 *Presentation of Financial Statements* (as revised in 2007) made a consequential amendment to IAS 28.11. This amendment is effective for annual periods beginning on or after 1 January 2009.

IAS 28 (previous version) paragraph 11 referred to changes in equity and required the following in applying the equity method:

Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. 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 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 of the investor.

IAS 28 (as amended) - para 11 no longer refers to changes in equity, but only changes in other comprehensive income (OCI):

Under the equity method, the investment in an associate is initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. 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. 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 in other comprehensive income of the investor (see IAS 1 Presentation of Financial Statements (as revised in 2007))*

As a result, paragraph 11 no longer states whether and where the investor should account for its share in the changes in the investee's equity (other than profit or loss, OCI and distributions) in applying the equity method. Such changes include for example:

- Gains and losses arising on associate's transactions with non-controlling interest (NCI) of its subsidiaries (recorded directly in equity in the associate's books)
- Liabilities recognised in respect of put options to NCI (recognised as a deduction of equity in the associates books)
- Movements in the share based payment reserves of the associate

Furthermore, IAS 1 (as revised in 2007) seems to preclude such items from being recognised directly in equity or OCI of the investor.

IAS 1.106 requires that changes in equity arising from transactions with owners in their capacity as owners be presented separately from non-owner changes in equity and that only owner changes in equity be presented in the statement of changes in equity. An associate is not part of the group as defined in IAS 27 and therefore any changes in its statement of changes in equity would not be regarded as transactions with owners from the investor's perspective.

IAS 1.7 defines other comprehensive income as *items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRSs.* IAS 28 is currently silent on the treatment of changes in equity of an associate from the investor's perspective and therefore it does not permit recognition of these items in other comprehensive income of the investor.

As a result, IFRS currently do not provide guidance on the accounting and presentation of changes in equity of an associate (other than profit or loss, OCI and distributions) from the investor's perspective when applying the equity method.

Current practice:
Various views currently exist to account for the investor's share in the changes in the equity of its associate:

View 1: Recognise the changes in the statement of changes in equity
View 2: Recognise the changes in the statement of other comprehensive income
View 3: Recognise the changes in the income statement
View 4: Do not account for the changes

Each of those views seems to have conflicts with some IFRS requirements as summarised below:

Conflicts with other IFRS requirements

View 1 – recognize changes in investor's equity	This is not a transaction with the owners of the group and thus there is no justification to recognize it directly in SOCIE in accordance with IAS 1.106 and IAS 1.109.
View 2 – recognize changes in investor's OCI	This is not an OCI item in accordance with the definition of OCI and the list of OCI items in IAS 1.7.
View 3 – recognize changes in investor's profit or loss	It is arguable whether this is in line with IAS 28.11.
View 4 – No transaction is recorded	Not in accordance with the definition of equity method in IAS 28.2,according to which the cost of the investment is adjusted thereafter for post-acquisition change in the investor's share of net assets of the investee.

Reasons for the IFRIC / IASB to address the issue:

There seems to be an unintended contradiction between the requirements of IAS 28.2, IAS 28.11 and IAS 1 that could result in inconsistent treatment in applying the equity method.

The issue is relatively widespread and causes divergent treatments in practice. On the other hand, it could be relatively easily fixed by improving the wording of IAS 28.11.

One possible way to resolve the conflict would be to clarify in IAS 28.11 that all other transactions of the investee that adjust the net assets of the investee without adjusting the investor's proportionate share in the net assets shall be recognised in the investor's profit or loss.