STAFF PAPER

IFRS Interpretations Committee Meeting

November 2011

Project	**Application of the equity method**		
CONTACT(S)	Gary Berchowitz	gberchowitz@iasb.org	+44 (0) 20 7246 6914

Introduction

1. At the September 2011 Board meeting, we presented a paper to the Board outlining four issues which the IFRS Interpretations Committee ('the Committee') had considered for annual improvements but had decided to propose that the Board not amend the relevant standards through Annual Improvements for various reasons (Refer to Agenda paper 7L, September 2011 Board meeting).

2. On all four of the issues presented, the Board agreed with the Committee's recommendation that the relevant standards should not be amended through Annual Improvements.

3. However, on the one issue relating to the application of the equity method under IAS 28 *Investments in Associates and Joint Ventures*, the Board requested that the Committee further analyse the issue and recommend how the Board might address the issue in the short term.

4. The intention of this paper is to:

   (a) Provide a summary of the issue to date;

   (b) Provide our view on the best way in which we think the Committee can achieve the Board's request; and

   (c) Obtain input from the Committee to help us develop a paper for a future Committee meeting.

Summary of the issue to date

5. This issue was presented to the Committee in the May 2011 meeting. The issue in summary is as follows (we have included the relevant extracts of the original paper in Appendix A):

   (a) The definition of the equity method in paragraph 3 of IAS 28 indicates that all changes in the net assets of an investee should be recognised by the investor.

   (b) However, as a result of a consequential amendment to IAS 28 paragraph 10, which describes how the equity method is applied, paragraph 10 no longer states **whether** and **where** the investor should account for its share of changes in the net assets that are not recognised in net profit or other comprehensive income ('OCI') of the investee ('other net asset 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) initial recognition of liabilities recognised in respect of put options on non-controlling interests.

6. At the May 2011 meeting, we proposed that the Committee should recommend to the Board that:

   (a) IAS 28 should be amended so that other net asset changes **should** be recognised by the investor and that these changes should be presented in the investors' OCI; and

   (b) This proposed amendment should be included in the 2010 – 2012 Annual Improvements.

7. However, the Committee disagreed with our recommendation. The reason for the Committee's disagreement is set out in paragraphs 69 and 70 of Agenda paper 7L of the 2011 Board meeting, which we have reproduced below:

> 69. Even though the Committee members acknowledged that the recognition of the investor's share of the other changes in the investee's net assets is a problem that arises in practice, they disagreed with the staff's proposed accounting treatment. In their view, OCI is not considered a residual change in net assets and instead they think that IAS 1 contains a clear list of items of income and expense that other standards have precluded from being recognised in profit or loss; consequently, only those items of income and expense that other IFRSs require or permit to be recognised outside profit or loss should be recognised in OCI.
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> 70. Most Committee members think that the default for recognising items of income and expense should be, instead, profit or loss. However, most Committee members think that the proposed accounting treatment would not faithfully represent the economic substance of the associate's transactions in the investor's financial statements. In their view, there is a need for a wider examination of specific transactions on a case-by-case basis, such as, the accounting from the investor's perspective, of transactions with non-controlling interests of an associate's subsidiaries, and the accounting for share based payments by an associate. In the view of the Committee members, the analysis of such changes would be better suited to being considered by the Board as part of a broader project to address other issues that have been brought to the Board's attention relating to IAS 28.

8. As explained in the introduction section to this paper, we presented the Committee's view to the Board at their September 2011 meeting. The Board agreed that the issue should not be addressed as part of Annual Improvements. However, the Board expressed a concern that it would be some time before they would be able to address IAS 28 more broadly as the Committee had suggested. Therefore the Board asked the Committee to further analyse **whether** and **where**

other net asset changes should be recognised in the investor's financial statements and to recommend how the Board might address this issue in the short term.

Staff recommendation for the approach to address the Board's request

9. As explained above, the Board is not planning to address in the short term any other issues that have been brought to the Board's attention relating to IAS 28 in a broader project. Therefore, we think that the Committee could analyse the issue raised in this paper without needing to consider IAS 28 more broadly. We think that there are three questions that need to be answered:

(a) **Question 1** – Should other net asset changes be recognised by the investor?

(b) **Question 2** – If other net asset changes should be recognised by an investor, where should the changes be presented by the investor?

(c) **Question 3** – What is the best way in which the Committee can help the Board to address this issue in the short term?

Questions for the Committee
1. Does the Committee agree with the three questions identified by the staff?
2. Does the Committee think that it can address the three questions without needing to consider IAS 28 more broadly or needing to consider any other issues previously brought to the Committee on IAS 28?
3. Does the Committee agree to take this issue onto its agenda, and if so, does the Committee think that there are additional questions that we need to consider in order to address the Board's request?

10. We propose to prepare a paper for a future Committee meeting. The approach in the paper would include the following:

(a) Identification of the issue (consistent with this paper);

(b) Identification of fact patterns which highlight the issue (the three identified in paragraph 5 of this paper as well as any others identified by the Committee members and others through planned Outreach activities);

(c) For each fact pattern provided, we would propose what we think is the most appropriate accounting and the rationale for our decision; and

(d) An analysis of whether the fact patterns considered together can be addressed by amending IAS 28 to include a principle that can be applied to determine whether particular other net asset changes should be recognised by the investor, and if so, whether they are recognised in:

  (i) profit or loss; or

  (ii) OCI; or

  (iii) equity,

  in a manner that reflects the nature of the other net asset change.

(e) Depending on the outcome from the analysis of the paper, we would then consider the extent of any proposed change to IAS 28 to determine if the change was within the scope of Annual Improvements or whether a separate amendment of IAS 28 would be required.

(f) We would then present the Committee's recommendation to the Board as either an Annual Improvement or a separate amendment to IAS 28.

Question for the Committee
1. Does the Committee agree with the proposed approach set out in paragraph 11 above? If not, how would the Committee propose we address the issue to best comply with the Board's request?

Appendix A – Extract of agenda paper 14 from May 2011 IFRS IC meeting

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 all 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

***Whether* the investor should account for *all* 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) **<u>View A:</u>** 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) **<u>View B:</u>** 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?