STAFF PAPER

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IFRS Interpretations Committee Meeting

IFRS IC meetings: May, Nov 2011
Board meeting: Sep 2011

Project	**IAS 28 *Investments in Associates and Joint Ventures***
Paper topic	Application of the equity method when an associate's equity changes outside of comprehensive income

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Introduction

1. The intention of this paper is to:

    (a) provide a summary of the previous meetings' discussions on this issue;

    (b) analyse several fact patterns and suggest the most appropriate accounting in each case; and

    (c) based on the results from considering the example fact patterns, determine whether an underlying principle can be developed to address the issue.

Background information

2. At the May 2011 meeting, the IFRS Interpretations Committee ('the Committee') received a request to:

    (a) address an inconsistency between the requirements of paragraphs 2 and 10 of IAS 28 (revised 2011)[1] and IAS 1 *Presentation of Financial Statements* (revised 2007) regarding the description and application of

[1] Paragraph 10 of IAS 28 (revised 2011) will replace paragraph 11 of IAS 28 (revised 2003) when IAS 28 (revised 2011) becomes effective. However, the wording in the paragraph that is the cause of this issue is unchanged and we have therefore referred to the IAS 28 (revised 2011) standard in this paper.

the equity method. This inconsistency arose because a consequential amendment was made to paragraph 10 of IAS 28 as part of the 2007 revision to IAS 1; and

(b) clarify the accounting for the investor's share of the 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 (OCI), or that are not distributions received ('other net asset changes'). For example, clarify how to recognise the changes in net assets of an associate that result from the associate entering into a transaction with its subsidiary's non-controlling shareholders.

3. We have included an extract from the relevant paper from the May 2011 meeting in Appendix B, which explains the issue in detail. In summary:

(a) the definition of the equity method in paragraph 2 of IAS 28 (revised 2011) indicates that all changes in the net assets of an investee should be recognised by the investor; however

(b) 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 of the associate that are not recognised in net profit or other comprehensive income of the associate (ie, 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 a non-controlling interest of its subsidiaries; and

(iii) initial recognition of liabilities recognised in respect of put options on non-controlling interests.

4. At the May 2011 meeting, the Committee decided that this issue was too broad to be addressed through an annual improvement and therefore recommended that the issue should be considered by the Board as part of a broader project to address IAS 28.

5. At the September 2011 Board meeting, the Board agreed with the Committee's recommendation that this issue could not be resolved through annual improvements. However, the Board asked if the Committee would further analyse the issue and recommend how the Board might address the issue in the short term, because the Board had concerns that it would be some time before the Board would have the capacity to address IAS 28 and equity accounting more broadly.

6. At the November 2011 meeting, the Committee agreed to reconsider this issue as a result of the Board's request. The Committee directed the staff to prepare an analysis to consider several fact patterns that illustrate the issue. The Committee asked the staff to attempt to develop a principle that might be useful to the Board in considering whether and how to amend IAS 28. This paper responds to the request of the Committee from the November 2011 meeting.

Example fact patterns for consideration

7. We have prepared six fact patterns based on the three examples previously identified by the submitter as well as additional examples identified by the Committee in the November 2011 meeting. For each fact pattern, we have tried to determine what the most appropriate accounting treatment is in the financial statements of the investor and the rationale for this treatment.

8. For each example, we have assumed that the requirements to classify the investment as an associate have been met. The examples analysed in detail in Appendix A are as follows:

   (a) Example 1: the associate issues additional share capital to parties other than the investor;

   (b) Example 2: the associate buys back ordinary shares from parties other than the investor;

   (c) Example 3: the associate recognises a liability and a corresponding decrease to equity on the initial recognition of a written put option over the associate's equity that would be gross settled if exercised;

(d) Example 4: the associate recognises a share-based payment charge with a corresponding entry in equity, for an equity-settled share-based payment;

(e) Example 5: the associate derecognises a debt instrument that the associate had previously issued because of the exercise of an equity conversion feature that was embedded in the debt instrument; and

(f) Example 6: the associate records a gain in equity as a result of the associate transacting with shareholders who have a non-controlling interest ('NCI') in its subsidiaries.

Summary of results from examples

9. The table below summarises our views regarding what we think the most appropriate accounting for each of the examples should be (the detailed analyses are included in Appendix A to this paper):

Example		**Should other net asset changes be *recognised* by the investor?**	**Where should the other net asset changes be *presented*?**
1	Associate issues additional share capital	Yes	Profit and loss
2	Associate share buy-back	No	N/A
3	Associate issues gross settled written put on own equity	No	N/A
4	Associate equity-settled share-based payment	N/A, there is no change in *net assets* for the share-based payment expense.	No impact to comprehensive income[2].
5	Associate issues a convertible debt instrument.	Yes	Profit and loss
6	Associate sells stake in its subsidiary to its NCI	Yes	Profit and loss

[2] In an equity-settled share-based payment, there is no change to the net assets, however there is the presentation issue of where the 'credit' side of the share-based payment is presented in the investors statement of comprehensive income. The summary table is intended to show we think that the 'credit' side should be included in the income from associate, resulting in a zero net impact to the investor.

Underlying principles illustrated from the examples

10. In working through the examples, we think that the most important question that needs to be addressed is whether, for the purposes of accounting for other net asset changes in associates, the equity method should be treated as either:

    (a) a one-line consolidation methodology; or

    (b) a valuation methodology.

11. We think that IAS 28 currently requires certain aspects of the equity method to be applied using a consolidation type methodology, while other aspects require the use of a valuation methodology, which is acknowledged in paragraph 26 of IAS 28:

    > Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures described in IFRS 10. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.

12. In considering the examples in this paper, for the purposes of accounting for other net asset changes, we think that the equity method should be treated as a valuation methodology. We reached this conclusion based on the following rationale:

    Disposals of a portion of an associate (refer to Appendix A, Examples 1, 5 and 6)

    (a) we think that a direct disposal of a portion of an associate should be recognised through net profit and loss, for example, an investor selling a 5 per cent shareholding in their associate to third parties;

    (b) consequently we think that an *indirect* disposal of a portion of an associate, for example as a result of the associate issuing new shares, should similarly be recognised through net profit and loss rather than through equity, as would be the case if a consolidation approach were used; and

(c) consequently, in the cases in which an associate writes a gross-settled call option or issues a convertible bond with an embedded derivative classified as equity, we think that the impacts to the net assets of the associate should be recorded through net profit and loss, because:

  (i) if the option is exercised, the new issue of shares by the associate will result in an *indirect* disposal of a portion of the associate from the investor's perspective and as discussed above, we think that indirect disposals should be presented through profit and loss; and

  (ii) the change in net assets of the associate as a result of the receipt of the implicit 'option premium' is linked to a possible dilution. As explained above, we think that dilution gains and losses represent indirect disposals and should therefore be recognised through net profit and loss.

Incremental acquisitions of a portion of an associate (refer to Appendix A, Examples 2 and 3)

(d) we think that a direct acquisition of an additional shareholding of an associate, for example an investor purchasing an additional 5 per cent shareholding in an associate from the other shareholders, should be accounted for at cost. When a direct investment in an associate is made, the investor has exchanged one asset (eg cash) for another asset (ie a share in the net assets of the associate), and therefore there is no *net* change in the investor's statement of financial position and consequently no impact to the investor's statement of comprehensive income. As explained in more detail in paragraph A10 of this paper, we think that there are sufficient differences between a purchase of a non-controlling interest in a subsidiary and an incremental acquisition of an associate to warrant different accounting treatments between those two transactions;

(e) consequently, we think that an *indirect* acquisition of a portion of an associate, for example as a result of the associate buying back its own shares from shareholders other than the investor, should similarly result in no change to the net assets of the investor. The difference between a direct and an indirect acquisition is that in an indirect acquisition, the consideration used to acquire the additional ownership stake comes from the associate rather than from the investor. Because the investor uses the assets of the associate to acquire an additional ownership stake in the associate, the net change to the carrying amount of the associate in the investor's financial statements is zero. In other words, we think that in substance, the investor has acquired an additional ownership stake in the associate using the associate's cash instead of the investor's cash, but that the transaction still represents the acquisition of an additional stake in the associate; and

(f) in the case in which an associate writes a put option that would be settled gross if exercised, we think that the initial recognition of the written put is linked to an indirect acquisition. As explained above, we think that an indirect acquisition should result in no net change in the assets of the investor.

Equity settled share-based payment transactions (refer to Appendix A, Example 4)

(g) As explained in more detail in paragraph A30 of this paper, the exercise of share-based payment awards granted by an associate to its employees will generally result in a dilution loss to the investor when the new shares are issued to the employees. We think that this dilution loss should be presented in net profit and loss. Consequently, we think that if the investor applies a consolidation approach, ie recognising their share of the share-based payment expense (which would be included in the income from the associate) with a corresponding 'credit' to equity, *in addition* to the dilution loss, this does not provide useful information. Consequently, we think that there should be a difference between:

(i) the accounting for a group equity-settled share-based payment in the consolidated accounts of the group; and

(ii) the accounting for an associate's equity-settled share-based payment by the investor.

13. We think that the underlying principles that could be applied in accounting for other net asset changes are:

(a) the accounting for other net asset changes requires a valuation-type methodology and not a consolidation-type methodology; and

(b) the valuation methodology would require:

(i) any reduction in the investor's shareholding to be treated as a disposal of the related interest, with the resulting gain or loss recognised in profit and loss;

(ii) any increase in the investor's shareholding to be treated as an acquisition of the related interest and to be accounted for at cost, ie no gain or loss would be recognised in comprehensive income; and

(iii) any transaction that does not affect the investor's share of the associate's net assets to be ignored for the purposes of applying the equity method.

Staff recommendation

14. As requested by the Committee, we analysed several fact patterns in an attempt to develop a principle that might be useful to the Board in considering whether and how to amend IAS 28.

15. On the basis of the results from our analysis, we think that the issue of other net asset changes is indeed broad as the Committee has previously stated and would require the Board to consider:

(a) whether the equity method requires a consolidation methodology or a valuation methodology as it applies to other net asset changes;

(b) whether a direct acquisition of an incremental portion of an associate should give rise to a gain or loss for the investor;

(c) whether an indirect acquisition (eg an associate share buy-back) or indirect disposal of an interest in an associate (eg an associate share issue) should follow the same accounting treatment as a direct acquisition or direct disposal respectively; and

(d) whether the principle in IFRS 2 *Share-based Payment*, that the 'credit' side of a group equity settled award affects equity of the parent, should be carried forward into equity accounting by the investor.

16. Consequently, our recommendation depends upon whether the Committee thinks:

(a) *an underlying principle exists:* if the Committee thinks that it can identify an underlying principle that is based on the analysis in this paper, we think that the Committee should present its views on this principle to the Board to determine whether the Board agrees with the principle. If the Board agrees with the Committee's principle, we recommend that the Committee should recommend that the Board should make a separate amendment to IAS 28 to address other net asset changes; or

(b) *the issue is too broad to develop an underlying principle:* if the Committee thinks that there is no underlying principle, or that it will not be able to determine the underlying principle without fundamentally reconsidering IAS 28, we recommend that the Committee should address the identified diversity in practice by proposing an interim clarification to IAS 28, through annual improvements, to require other net asset changes to be recognised directly in equity for the investor. We think that this would 'reset' the guidance on other net asset changes to the version of IAS 28 that was effective before the consequential amendment in 2007. The rationale for the amendment would be:

(i) to provide clarity for preparers of financial statements and ensure comparability. Currently, the lack of specific guidance on this issue may contribute to diversity in practice in accounting for other net asset changes; and

(ii) because the Board did not redeliberate the principles of equity accounting when the consequential amendment was made to IAS 28 in 2007, the proposed annual improvement would bring the requirements for other net asset changes back in line with those that the Board *had* deliberated in developing the previous version of IAS 28 (revised 2003).

Questions for the Committee
1. Does the Committee agree with the proposed principle to address other net asset changes explained in paragraph 13 to this paper? 2. If the Committee does not agree with the staff analysis of the proposed principle to address other net asset changes, does the Committee think that there *is* an underlying principle that it could develop within a reasonable time? 3. If the Committee agrees that an underlying principle exists for other net asset changes (either the principle proposed in this paper or something else), does the Committee agree with the staff recommendation that the Committee should recommend to the Board that it should amend IAS 28? 4. If the Committee does not think that an underlying principle exists for other net asset changes, or that it would not be able to develop such a principle within a reasonable time, does the Committee agree with the staff recommendation to propose an annual improvement to IAS 28 to require other net asset changes to be presented in equity?

Appendix A—Example fact patterns

Example 1: Associate issues additional share capital

A1. Entity H is the investor in an associate, Entity A. At 1/1/20X2:

- Entity H owns 33 per cent of Entity A and Entity H's investment in associate A is a carrying amount of CU15,000[3];
- Entity A's net assets are CU45,000;
- Entity A issues new shares in order to raise CU10,000 additional capital but Entity H does not participate in the share issue. As a result of this, Entity H's holding in Entity A drops to 30 per cent.

Analysis of the transaction

A2. As a result of issuing the additional shares, there are two economic impacts to Entity H's holding in Entity A:

- Entity H's holding in Entity A drops to 30 per cent, meaning that Entity H loses 3 per cent of its previous holding—a 'loss' of CU1,350
- Entity H is entitled to 30 per cent of the new funds that were obtained—a 'gain' of CU3,000.

A3. The net impact to Entity H is that their share in Entity A has increased by CU1,650 as a result of the share issue by Entity A.

Question 1—Should Entity H record the increase in its investment in Entity A?

A4. We think that Entity H should recognise the increase in its investment in Entity A, ie, Entity H should increase the carrying amount of its investment in Entity A by CU1,650, because:

[3] In these examples, monetary amounts are denominated in 'currency units (CU)'

(a) the issue of the shares by Entity A has economic consequences for Entity H. Not to record the impact of these consequences would not provide useful information to the users of Entity H's financial statements.

(b) before the revision to IAS 28 as a result of the 2007 amendments to IAS 1, the change in Entity H's stake as a result of other changes in equity would have been recognised as a change to the carrying amount of Entity H's investment in Entity A. The Basis for Conclusions of IAS 1 and IAS 28 make no mention of an intended change to the equity method as a result of the 2007 amendments to IAS 1. Consequently, we think that the consequential amendment was not intended to amend the *recognition* of other net asset changes (the *presentation* of these changes is discussed in in the following Question 2); and

Question 2—Where should Entity H record the increase in its investment in Entity A (the 'credit side' in this example)?

A5. We think that Entity H should recognise the increase of its investment in Entity A through *net profit*. As a result of an indirect disposal of a portion of Entity H's shareholding in Entity A, Entity H has realised a gain of CU1,650 when comparing the cost of its investment in Entity A to the change in the net assets of the associate. We note that the Committee considered a similar issue in the July 2009 meeting and the conclusion at the time indicates that the Committee thinks that all disposals require recognition through net profit and loss (emphasis added):

> The IFRIC noted that paragraph 19A[4] of IAS 28 provides guidance on the accounting for amounts recognised in other comprehensive income when the investor's ownership interest is reduced, but the entity retains significant influence. The IFRIC noted that there is no specific guidance on the recognition of a gain or loss

[4] Paragraph 19A was deleted as part of the 2011 revision to IAS 28. However, the same requirements were carried forward in paragraph 25 of IAS 28 (revised 2011)

> resulting from a reduction in the investor's ownership interest resulting from the issue of shares by the associate. However, the IFRIC also noted that reclassification of amounts to profit or loss from other comprehensive income is generally required as part of determining the gain or loss on a disposal. **Paragraph 19A of IAS 28 applies to all reductions in the investor's ownership interest, no matter the cause**.

A6. In addition, we think that the decision not to participate in the share issue is economically similar to the sale of a portion of the associate. In the case in which an investor sells a portion of the associate, but retains significant influence, we think that the difference between the cash received and the portion of the associate that is derecognised would be recorded through net profit or loss, because:

(a) when a portion of an asset is derecognised in exchange for cash, we think that the most useful presentation of any gain or loss is through net profit, because any difference between the historical cost of the asset and its fair value is realised; and

(b) this logic is consistent with the Committee's view as reported in the July 2009 *IFRIC Update* (as reproduced above).

Example 2: Associate share buy-back

A7. Entity H is the investor in an associate, Entity A. At 1/1/20X2:

- Entity H owns 30 per cent of Entity A and Entity H's investment in associate A is a carrying amount of CU15,000;
- Entity A's net assets are CU45,000;
- Entity A enters into a share buy-back programme and, as a result, Entity A buys back a portion of its shares currently in issue from shareholders other than Entity H. Entity A pays CU5,000 to buy back its shares. As a result of this, Entity H's holding in Entity A increases to 33.33 per cent.

Analysis of the transaction

A8. Entity H has acquired an incremental stake in its associate, Entity A, because its ownership percentage has increased. In substance, we think that this is economically the same as Entity H acquiring an incremental stake in Entity A by acquiring the shares directly from Entity A's other shareholders.

Question 1—Should Entity H record the increase in its investment in Entity A?

A9. We think that the accounting treatment for Entity H should be consistent with the treatment that would follow if Entity H were to acquire an incremental stake in Entity A *directly* from the other shareholders of Entity A.

A10. However, IAS 28 does not provide guidance on how an investor should account for the direct purchase of an incremental stake in an associate when this does not result in a change in significant influence, for example, if an investor owns 25 per cent of an associate and pays cash directly to the other shareholders for an additional 5 per cent of the associate. We think that there are two possible views for how an investor would account for a direct incremental stake in an associate:

(a) ***View 1—zero cost acquisition approach***: proponents of this view think that when an incremental stake is acquired by the investor directly from the other shareholders of an associate, the cost of the acquisition is added to the carrying amount of the associate balance in the investor's financial statements and no gain or loss is recognised on the transaction. The investor has exchanged one asset (eg cash) for another asset (ie a share in the net assets of the associate), and therefore proponents of this view think that there is no *net* change in the investor's statement of financial position and consequently no impact to the investor's statement of comprehensive income.

A11. ***View 2—dilution approach***: proponents of this view think that when an additional stake in an associate is acquired directly from the other shareholders, there is a net impact upon the investor's claim on the net assets of the associate that needs to be recognised. In other words, an acquisition of an incremental stake in an associate is treated in the same way as a disposal of a portion of the associate. This rationale is based on the assumption that the equity method in IAS 28 only requires the initial acquisition of the stake in the associate that results in significant influence to be recognised at cost in accordance with IAS 28 paragraph 10. After the initial recognition of an associate at cost, any incremental acquisitions need to take into account the change in the net asset position and must recognise the corresponding impact upon the carrying amount of the investment. This approach follows the same rationale as is followed in consolidated accounts when a parent acquires an incremental stake in the equity of a subsidiary from the non-controlling shareholders. Consequently, for the indirect acquisition described in this example, the application of the two views would be as follows:

(a) Applying the *zero cost acquisition approach*, entity H:

(i) increases its investment in Entity A by the cost that it has 'paid' to acquire the additional stake in Entity A, which in this case, is Entity H's share of the cash that Entity A paid to buy back its shares (CU5000 ^{x} 30 per cent); and

(ii) decreases its investment in Entity A by the decrease in the net asset position as a result of the cash that is paid to the other shareholders, similarly to the way in which an investor reduces its investment in an associate when a dividend is paid (CU5000 x 30 per cent).

In this example, the investor uses the net assets of the associate as consideration for the incremental ownership stake acquired, rather than using the investor's own cash resources as consideration. The net impact to Entity H's investment in Entity A is zero. This treatment would result in the same change to the net assets of Entity H if Entity H acquired the additional shareholding in Entity A directly from the other shareholders of Entity A for cash. For example, Entity H could have achieved the same ownership holding if it had paid CU1,667 directly to the other shareholders of Entity A in order to obtain an incremental 3.33 per cent ownership stake in Entity A.

(b) Applying the *dilution approach*, Entity H would decrease its investment in Entity A by CU167, made up of:

(i) *decrease from cash paid:* a decrease in its investment in Entity A by its share of the cash 'paid' by entity A to buy-back its shares, ie CU1,500 (CU5,000 x 30 per cent); and

(ii) *increase in interest acquired:* an increase in its investment in Entity A by the share of net assets gained because Entity H's ownership percentage in Entity A has increased, ie CU1,333 (CU40,000 x 3.33 per cent).

A12. We think that either of the two approaches explained above, namely the zero cost acquisition approach or the dilution approach, are acceptable interpretations of the requirements of IAS 28, because IAS 28 is not explicit on whether its core principle is that of a one-line consolidation or a form of valuation technique. In other words:

(a) if IAS 28 is intended to have as its core principle a valuation methodology that recognises each tranche in an associate at cost with subsequent changes in the net assets related to that tranche's ownership interest as income of the investor, then we think that the zero cost approach is more appropriate; however

(b) if IAS 28 is intended to have as its core principle a consolidation methodology, then we think that the dilution approach is the more appropriate approach, because it is consistent with the treatment that would be applied for a subsidiary share buy-back.

A13. For the purposes of this example only, we think that the zero cost approach, as explained above, is the more appropriate accounting treatment because:

(a) we do not think that the recognition of a gain or loss on an incremental *acquisition* of an associate provides useful information (even if this is presented in equity as discussed below) because we think it generally does not make sense to recognise a gain or loss on the *acquisition* of an asset; and

(b) we think that there is a difference between obtaining an incremental ownership stake from a shareholder with a non-controlling interest (NCI) in a subsidiary when compared to obtaining an incremental ownership stake in an associate. In the case of a subsidiary, all of the net assets of the subsidiary are already recognised by the parent. Consequently, the adjustment that is made on the acquisition of an NCI is to account for the relative claims on the assets that are already recognised by the group as explained in paragraph BCZ175 of IFRS 10:

> BCZ175 By acquiring some, or all, of the non-controlling interests the parent will be allocated a greater proportion of the profits or losses of the subsidiary in periods after the additional interests are acquired. The adjustment to the controlling interest will be equal to the unrecognised share of the value changes that the parent will be allocated when those value changes are recognised by the subsidiary. Failure to make that adjustment will cause the controlling interest to be overstated.

This situation is different for an associate: there is no need to allocate the relative rights between the equity holders because the investor has not recognised all of the associate's net assets and the investor has not recognised the other equity holders in its financial statements.

Question 2—Where should Entity H record the increase in its investment in Entity A?

A14. As explained above, we think that the zero cost approach is the more appropriate approach for this example. However, if the dilution approach is applied to the transaction, we think that there are two alternatives for presenting the net decrease in the carrying amount of the investment (CU167) in Entity H's financial statements:

(a) ***View 1—profit and loss***: proponents of this view think that the impact of the indirect acquisition should be treated in a manner similar to that obtained on a dilution, because in both cases, the investor's claim on the net assets of the associate has changed. As explained in Example 1 above, we think that a dilution gain or loss should be recognised through net profit and loss.

Furthermore, the requirement to record transactions with shareholders of the same group through equity only arises when those shareholders are part of the same group. A group is defined in IFRS 10 Appendix A as 'a parent and its subsidiaries'. Because Entity A is not part of the Entity H group, transactions among owners of the Entity A group do not have the same accounting requirements when considered by Entity H. In other words, because Entity H has not consolidated Entity A and recognised the other shareholders of Entity A as a part of Entity H's equity, transactions between Entity H and the other shareholders of Entity A are not equity transactions.

(b) ***View 2—equity***: proponents of this view think that the impact of the indirect acquisition should be treated in a manner similar to that obtained on an incremental acquisition of a stake in a subsidiary. Because the dilution approach, as explained above, is based on the principle that equity accounting is a one-line form of consolidation, proponents of this view think that the changes in the net asset position should be presented based on the same principle, ie through equity.

Furthermore, proponents of this view think that paragraph BCZ168 of the Basis for Conclusions of IFRS 10 indicates that the rationale for recording the change in net assets through equity is not due to a parent/subsidiary relationship, but is instead due to the fact that the transaction occurred between owners in their capacity as owners:

> BCZ168 The Board decided that after control of an entity is obtained, changes in a parent's ownership interest that do not result in a loss of control are accounted for as equity transactions (ie transactions with owners in their capacity as owners). This means that no gain or loss from these changes should be recognised in profit or loss. It also means that no change in the carrying amounts of the subsidiary's assets (including goodwill) or liabilities should be recognised as a result of such transactions.

Proponents of this view also think that before the revision to IAS 28 as a result of the 2007 amendments to IAS 1, IAS 28 was clear that other net asset changes should be presented in equity. The Basis for Conclusions of IAS 1 and IAS 28 make no mention of an intended change to the equity method as a result of the 2007 amendments to IAS 1. Consequently, proponents of this view think that the consequential amendment was not intended to amend the presentation of these changes.

A15. Assuming that the dilution approach (as explained above) is applied to the transaction, we think that the net decrease of CU167 in the carrying amount of the associate in Entity H's financial statements should be recognised in equity for the reasons set out in the preceding paragraph.

Example 3: Written put option over associate's own equity

A16. Entity H is the investor in an associate, Entity A. At 1/1/20X2:

- Entity H owns 33 per cent of Entity A and Entity H's investment in associate A is a carrying amount of CU15,000;
- Entity A's net assets are CU45,000;
- Entity A writes a put option over a fixed number of its own equity shares for a fixed amount of cash that cannot be net settled. The present value of the exercise price at the date that Entity A writes the put option is CU3,000. Entity A receives CU300 as consideration for writing the put option (ie, the option premium). Consequently, at 1/1/20X2, Entity A recognises a liability of CU3,000, cash of CU300 and a reduction in its own equity of CU2,700.
- Entity A cannot predict whether the put option will be exercised. During the option period, dividends accrue normally to the holder of the put option.
- As a result of Entity A's put option, Entity H's claim on the carrying amount of Entity A's net assets decreases by CU900 (CU2700 x 33 per cent).

Analysis of the transaction

A17. In this example, Entity A accounts for the put option as a potential buy-back of its own shares, which is why the accounting requires the initial liability to be recognised through equity. We think that there are similarities in this fact pattern to the fact pattern in Example 2 above. In Example 2, the associate purchased its own shares from shareholders other than Entity H. In this Example 3, the associate has entered into a potential share buy-back as a result of the written put option.

A18. However, unlike a share buy-back, the written put option in this example does not give Entity H a present ownership interest on the shares subject to the put option. In other words, in this example, it is not clear whether Entity H obtains the benefits associated with the potential additional ownership stake in Entity A because it is not clear at 1/1/20X2 whether the put option will be exercised.

Question 1—Should Entity H record the change in its investment in Entity A?

A19. We think that Entity H should record the change in its stake in Entity A because:

(a) the issue of the put option by Entity A has economic consequences for Entity H. Not to record the impact of these consequences would not provide useful information to the users of Entity H's financial statements.

(b) Before the revision to IAS 28 as a result of the 2007 amendments to IAS 1, the change in Entity H's stake as a result of other changes in equity would have been recognised as a change to the carrying amount of Entity H's investment in Entity A. The Basis for Conclusions of IAS 1 and IAS 28 make no mention of an intended change to the equity method as a result of the 2007 amendments to IAS 1. Consequently, we think that the consequential amendment was not intended to amend the *recognition* of other net asset changes (the *presentation* of these changes is discussed in the following Question 2).

A20. Because we think that this transaction is similar to a share buy-back by the associate, we think that there are alternative views for the amount by which Entity H should adjust its investment in Entity A:

(a) ***View 1—zero cost acquisition approach***: this view is based on the zero cost acquisition approach explained in Example 2 above. This views each incremental ownership acquisition as being a separate tranche of the associate to which the equity method is applied. In this example, Entity H would recognise:

(i) an increase in its investment in Entity A by the cost that it has 'paid' to acquire the new tranche (ie the potential ownership stake). The cost in this case is Entity H's share of the net liability that Entity A has incurred (CU2,700 x 33 per cent); and

(ii) a decrease in its investment in Entity A through its share of the decrease in the net asset position as a result of the recognition by Entity A of the written put liability (CU2,700 x 33 per cent).

(b) ***View 2A—dilution approach using a 'two-step' process***: this view is based on the dilution approach explained in Example 2 above, ie a decrease *or* increase in the investor's share of the associate's net assets should be accounted for in the same way. Consequently, Entity H should recognise the change in its stake in Entity A. However, as explained in the analysis of the transaction above, Entity H does not obtain the benefits associated with the potential additional ownership stake in Entity A at 1/1/20X2. Consequently, the accounting for the first 'step' of the transaction would require Entity H to decrease the carrying amount of its investment in Entity A by CU900 at 1/1/20X2. If the put option is exercised, Entity H would record the change in its investment in Entity A at that time (ie a two-step transaction). The rationale for this view is based on the guidance in IFRS 10 paragraphs B89 and B90[5]:

> B89 When potential voting rights, or other derivatives containing potential voting rights, exist, the proportion of profit or loss and changes in equity allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined solely on the basis of existing ownership interests and does not reflect the possible exercise or conversion of potential voting rights and other derivatives, unless paragraph B90 applies.
>
> B90 In some circumstances an entity has, in substance, an existing ownership interest as a result of a transaction that currently gives the entity access to

[5] IAS 27 (Amended 2008) included similar guidance in paragraph IG5. Paragraph IG 5 of IAS 27 (Amended 2008) specifically referred to IAS 28 in addition to IAS 27.

> the returns associated with an ownership interest. In such circumstances, the proportion allocated to the parent and non-controlling interests in preparing consolidated financial statements is determined by taking into account the eventual exercise of those potential voting rights and other derivatives that currently give the entity access to the returns.

(c) ***View 2B—dilution approach using a 'one-step' process***: consistently with View 2A above, this view is based on the dilution approach explained in Example 2, ie a decrease *or* increase in the investor's share of the associate's net assets should be accounted for in the same way. Consequently, Entity H should recognise the decrease of its stake in Entity A as a result of the written put option. However, unlike in View 2A, at the same time that the decrease is recognised for the written put option, Entity H would recognise the change in the net assets that would occur assuming that the put option will be exercised (ie a one-step transaction). In other words, Entity H would record the net impact on its share in the assets of Entity A as if the counterparty to the written contract had exercised the put option. The rationale for this view is that recognising only the impact of the written put option (without recognising the impact of exercising the option) would distort the economic reality of the transaction. At the time that a written put option is issued, it will generally result in a reduction in the carrying amount of the associate, because the strike price (equivalent to the liability recognised) generally exceeds the option premium, ie the cash received. However, it is only when the counterparty chooses to exercise the option, or lets the option lapse, that the overall economic impact on the investor (Entity H) will be known. In other words, at some point in time after the put option is issued, either:

(i) the counterparty will exercise the option, and this will result as an increase in the carrying amount of the associate balance in Entity H because Entity H's ownership stake will increase without a reduction in the net assets of Entity A (in

Entity A's financial statements, the exercise of the option is treated as a settlement of a liability for cash, resulting in no net asset change); or

(ii) the counterparty will let the option lapse, which will result in an increase in Entity H's share of the net assets of Entity A, because from Entity H's perspective, the net assets of Entity A will have increased with no change to Entity H's ownership percentage (in Entity A's financial statements, the option lapse is treated as a reclassification of a liability to equity resulting in an increase in net assets).

The impact of recognising only the written put option part of the transaction will result in a reduction in the carrying amount of Entity H's investment in Entity A, but the investment in Entity A will then increase at some later time if the option is exercised or lapses. Proponents of this view think that the guidance in paragraphs B89 and B90 of IFRS 10 do not explicitly refer to equity accounting (even though the equivalent guidance in IAS 27 (Amended 2008) did specifically refer to IAS 28). Consequently, proponents of this view think that IAS 28 is a hybrid valuation-consolidation technique and that not all of the consolidation requirements need to be followed (specifically, B89 and B90).

In addition, proponents of this view argue that paragraph B90 of IFRS 10 requires an entity to analyse the substance of the arrangement to determine the appropriate accounting. As explained above, proponents of this view think that treating the transaction as a two-step process distorts the substance of the transaction.

A21. We think that there are valid arguments for applying each of the views explained above. However, consistently with our rationale in Example 2 above, we think that the zero cost acquisition approach is the most appropriate approach for this example. We think that a gross settled written put option can be viewed as either:

(a) a share buy-back in which the payment has been deferred (if the put option is exercised); or

(b) the buy-back of shares with a subsequent reissue of the shares at a later point in time (if the put option lapses).

In either scenario, at the time that the put option liability is initially recognised, we think that it is appropriate to account for this in the same way as for a share buy-back by the associate and thus apply the zero cost acquisition approach.

Question 2—Where should Entity H record the change in its investment in Entity A's net assets?

A22. As explained above, we think that the zero cost approach is the more appropriate approach for this example. If the zero cost approach is applied, then there is no net change in Entity H's investment in Entity A at the time that the written put option is issued, as explained above in paragraph A10(a). Because in this example we have assumed that Entity H does not have a present ownership interest in the potential new tranche of ownership, it would equity account zero for any related profits that are earned by Entity A while the put option is outstanding. At a later point in time either:

(a) *the put option is exercised*. At this time, there is no change in the net assets of Entity A. However, from this point forward, Entity H will recognise its share of the change in net assets of Entity A relating to the incremental ownership stake/tranche; or

(b) *the put option lapses*. At this time, this would be treated as Entity H disposing of the incremental ownership stake/tranche. Entity H's net disposal gain or loss would be CU100 because:

(i) Entity H would be disposing of its holding at a cost of CU900; and

(ii) Entity H's share of the net assets of Entity A would increase when the put liability is derecognised through equity in Entity A (CU3000 ^{x} 33 per cent).

Together, these amounts represent Entity H's share of the net gain that Entity A would achieve from the written put option premium (CU300 x 33 per cent).

A23. However, assuming that the dilution approach is applied to the transaction, we think that there are three alternatives for Entity H to record the change in net assets of Entity A when the put option is issued:

(a) ***View 1—profit and loss*:**

The accounting rationale for recording the written put option liability through equity in Entity A's financial statements is that Entity A is accounting for the potential buy-back of its *own shares* as a result of the written put option. If Entity A purchased its own shares from the market, although this would be recorded through equity in Entity A's financial statements, the transaction would give rise to a dilution gain or loss from Entity H's perspective. As explained in Example 2 above, one of the views is that a dilution gain or loss on the issue of shares by the associate should be presented through net profit and loss. Because the recognition of the liability represents a part of a share buy-back by the associate, proponents of this view think that this part of a possible share buy-back should also be presented through net profit. When the option is exercised or lapses, the impact of that part of the transaction would also be presented through net profit because it is linked to a share buy-back.

If the two-step process as explained in paragraph A20(b) above is followed, the impacts on net profit as a result of the two parts of the transaction would be recognised in the accounting periods in which each of the steps occurred.

If the one-step process as explained in paragraph A20(c) above is followed, the impact on net profit when the option is issued would be accounted for in a similar manner as for a dilution gain or loss on a share buy-back. If the option lapses in the future, the impact on net profit would be accounted for in a similar manner as for the dilution gain or loss on the issue of new shares by the associate.

(b) ***View 2—OCI if two-step process is followed*****:**

Similarly to the rationale in View 1 above, proponents of this view believe that the overall impact of the transaction, ie the written put option plus the impact of the option being exercised or lapsing, should be recognised through net profit. However, because the overall impact of the transaction is split into two parts if the two-step process is followed, proponents of this view do not think that it provides useful information to present only one half of the transaction in net profit when there is a related step to the transaction that will still occur – this rationale is analogous to that applied in cash flow hedge accounting. Consequently, the presentation of the change in the associate's carrying amount for the written put option is recognised initially through OCI. When the second part of the transaction occurs (ie, the option is exercised or lapses) the portion initially recognised through OCI is recycled through net profit. Proponents of View 2 think that the overall impact of what is a single transaction is presented in net profit once the final outcome of the transaction is known, ie

(i) either a dilution gain or loss on an associate share buy-back; or

(ii) a net gain on writing a put option that is not exercised.

(c) ***View 3—equity*****:**

Proponents of this view think that the net asset changes should be presented in equity because:

(i) IAS 28 paragraph 26 explains 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. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary

are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

Because the principles in IFRS 10 paragraph 23 explain that transactions with non-controlling shareholders should be accounted for through equity, then if these consolidation principles are applied for equity accounting, the accounting treatment followed by Entity A should be carried forward into the equity accounting of Entity H; and

(ii) before the consequential amendment to IAS 28, the wording in IAS 28 was clear that changes in the net assets of the associate that were not recognised through net profit in the associate should be recognised through equity in the investor (refer to paragraph A7 of Appendix A to this paper). The Basis for Conclusions of IAS 1 and IAS 28 make no mention of an intended change to the equity method as a result of the 2007 amendments to IAS 1. Consequently, requiring Entity H to recognise all of the changes as a result of the written put option and its subsequent exercise or lapse in equity would maintain the previous accounting requirements. In other words, the investor should mirror the associate's presentation of all of the changes in the net assets of the associate.

A24. We acknowledge that the issue of written put options is broad and certain aspects are currently being considered by the Committee (refer to the November 2011 *IFRIC Update*). We think that each of the views expressed above has relative benefits and disadvantages.

A25. We think, for the purposes of this example only, that the most appropriate accounting treatment is for the investor (Entity H) to apply the zero cost acquisition approach as explained above, because we think that the accounting for this type of transaction should be consistent with that of an outright share buy-back by the associate (Example 2 above). Consequently, for the same reasons as those in Example 2, we think that the zero cost acquisition approach is the more appropriate treatment, ie:

(a) we do not think that the recognition of a gain or loss on an incremental *acquisition* of an associate provides useful information (even if this is presented in equity) because we think it generally does not make sense to recognise a gain or loss on the *acquisition* of an asset; and

(b) we think that there is a difference between obtaining an incremental ownership stake from an NCI in a subsidiary and obtaining an incremental ownership stake in an associate. In the case of a subsidiary, all of the net assets of the subsidiary are already recognised by the parent, and so it makes sense that an adjustment is required on an incremental acquisition of the subsidiary's equity to account for the different equity holders' rights to those net assets.

Example 4: Associate recognises an equity settled share-based payment

A26. Entity H is the investor in an associate, Entity A. At 1/1/20X2:

- Entity H owns 33 per cent of Entity A and Entity H's investment in associate A is a carrying amount of CU15,000;
- Entity A's net assets are CU45,000;
- Entity A grants its employees an equity-settled share-based payment. The grant date fair value is CU9,000 and the only vesting condition is a three-year service condition that all employees are expected to meet.

At 31/12/20X2, Entity A has recognised an expense of CU3,000 relating to the share-based payment.

Analysis of the transaction

A27. In this example, there is no change in the net assets of Entity A during the vesting period. In Entity A's financial statements, the accounting treatment is to recognise an employee expense with a corresponding increase in equity. Consequently, the question is not whether Entity H should record its share of the changes in net assets of Entity A (because there are none), but rather how Entity H should *present* Entity A's share-based payment. We think that the alternative views are:

(a) **View 1—gross approach**:

Entity H should equity account its income from associate in its statement of comprehensive income. In doing this, Entity H would automatically pick up its shares of the annual share-based payment expense (CU1,000) because this is included in Entity A's net profit. At the same time, Entity H would recognise an increase in equity for its share of the 'credit' side of Entity A's share-based payment.

If the equity method is intended to be a form of consolidation, then consistently with the principles of consolidation and the definition of an equity settled share-based payment in Appendix A of IFRS 2, Entity H should record an increase in equity for the credit side of the transaction.

Entity H is giving up a portion of its equity in Entity A to obtain employee services. Proponents of this view think that whether Entity H gives up its own equity, or that of its associate, should not change the substance of the share-based payment.

(b) **View 2—net approach:**

Entity H should equity account its income from associate in its statement of comprehensive income. In doing this, Entity H would automatically pick up its shares of the annual share-based payment expense (CU1,000) because this is included in Entity A's net profit. At the same time, however, Entity H would increase the income from associate for its share of the 'credit' side of Entity A's share-based payment. The net result would be that Entity H would *not* record any expense for its share of Entity A's equity-settled share-based payment.

If the equity method is intended to be a form of valuation technique, then from the perspective of Entity H, the share-based payment has not resulted in any change in the net assets or ownership of its share in Entity A. The impact of the share-based payment will be recognised when, or if, the employees' awards vest and Entity H's claim on the net assets of Entity A decrease as a result of a reduced ownership interest (ie, there is a dilution gain or loss).

A28. We think that the net approach, as explained above, is the more appropriate treatment in this example. If the employees' awards vest and the employees ultimately end up with shares, this will generally result in a dilution loss to Entity H; for example when the awards are options with a zero strike price or shares for no consideration. In Entity A's financial statements, the ultimate issue of the shares would be recorded through equity. However, as explained in Example 1 above, the deemed disposal or dilution for Entity H would have an impact upon the net profit and loss of Entity H when the shares are issued. In other words, applying the gross approach would result in:

(a) recognition of Entity H's share of the equity settled share-based payment expense through net profit and loss *as well as*;

(b) a second expense in the form of a dilution loss when the shares are issued.

Consequently, we think that the gross approach would provide less useful information.

Example 5: Associate debt is converted into equity

A29. Entity H is the investor in an associate, Entity A. At 1/1/20X2, Entity A issues a one-year convertible debt instrument with a par value of CU10,000. The terms of the liability are such that it can be converted into a fixed number of ordinary shares. The convertible debt instrument is initially recognised in Entity A's financial statements as a liability of CU9,000 and an embedded derivative classified as equity of CU1,000 (this represents the 'option premium' received by Entity A on the date that it issues the debt). At the time that the convertible debt is issued, it is unknown whether the counterparty will exercise the conversion feature at the end of the year.

A30. At 31/12/20X2:

- Entity H owns 30 per cent of Entity A and Entity H's investment in Associate A is a carrying amount of CU15,000;
- Entity A's net assets are CU45,000 including the convertible debt liability, which has a carrying value of CU10,000 at that time; and
- the counterparty to the debt instrument exercises the conversion option, resulting in Entity H's ownership decreasing to 25 per cent.

Analysis of the transaction

A31. As a result of issuing the additional shares, there are two economic impacts upon Entity H's holding in Entity A:

- Entity H's holding in Entity A drops to 25 per cent, meaning that Entity H loses 5 per cent of its previous holding—a 'loss' of CU2,250.
- Entity H is no longer exposed to its share of the future outflow from the liability—a 'gain' of CU2,500.

A32. The net impact upon Entity H is that its share in Entity A has increased by CU250 as a result of the debt conversion.

A33. We think that a convertible debt instrument is economically no different to issuing two separate financial instruments at the same time:

(a) a debt instrument without a conversion feature; and

(b) a fixed-price written call option that can only be gross-settled.

A34. Consequently, we think that the issue can be simplified by considering how an investor would account for a call option written by its associate over the associate's own equity where the option will be gross-settled if exercised.

Question 1—Should Entity H record the change in its investment in Entity A?

A35. We think that Entity H should record the change in its net assets in Entity A at the time that the convertible debt is issued (CU1,000 ^{x} 30 per cent). Before the revision to IAS 28 as a result of the 2007 amendments to IAS 1, the change in Entity H's stake as a result of other changes in equity would have been recognised as a change to the carrying amount of Entity H's investment in Entity A. The Basis for Conclusions of IAS 1 and IAS 28 make no mention of an intended change to the equity method as a result of the 2007 amendments to IAS 1. Consequently, we think that the consequential amendment was not intended to amend the *recognition* of other net asset changes (the *presentation* of these changes is discussed in in the following Question 2).

A36. We think that there are similarities in this fact pattern to the one in Example 3 above. In Example 3, the associate issued a written put option that could only be settled gross. Because we have assumed in the fact pattern that the convertible bond holder does not, in substance, have a present right to the equity ownership stake related to the convertible bond, a two-step process (as explained in more detail in paragraph A20(b) of Example 3 above) is applied.

A37. In other words, in this example we think that Entity H should record the change in the net assets in Entity A, and this will represent the impact of the implicit 'option premium' received on issue of the convertible bond (ie the CU1,000 recorded in Entity A's equity). Entity A should not assume that the conversion feature will be exercised at the time that the bond is issued (ie the two-step process explained in Example 3 above).

A38. If the conversion option is exercised later, this would be treated by Entity A as the issue of new shares with the consideration received being the settlement of the debt instrument. Consequently, Entity H would account for the issue of new shares by Entity A in the same way as that explained in Example 1 when the associate issues new shares.

Question 2—Where should Entity H record the change in its investment in Entity A's net assets?

A39. At the date that the associate writes the call option, it should receive an option premium (in this Example 5, this is represented by the CU1,000 classified as equity). We think that the premium received on the written call option represents one of the parts of what might ultimately be a share issue by the associate and a dilution from the perspective of the investor.

A40. We think that the rationale in accounting for this type of transaction is similar to the one described in Example 3: ie, the associate writes a put option on its own equity that if exercised must be settled gross. When we analysed Example 3, our view was that a written put option is a part of a potential share buy-back by the associate and that the most appropriate accounting treatment was the zero cost acquisition approach (refer to paragraph A20(a) above). The rationale for that conclusion was that the constituent transactions making up the potential share buy-back (ie, the issue of the put option and the subsequent exercise or lapse of the put option) should be accounted for in a similar manner to the investor acquiring an incremental stake directly in the associate. In other words, if no gain or loss is recognised on a share buy-back by the associate and a gross settled written put option represents a portion of a share buy-back, then consequently no gain or loss should be recognised on a gross-settled written put option.

A41. However, in the case of a gross-settled written call option, the call option represents a portion of a potential share issue. As explained in Example 2 above, we think that a share issue by the associate does give rise to a gain or loss, because it represents a deemed *disposal* of a portion of the investor's share.

A42. Consequently, we think that there are alternative views on the accounting for the issue of a gross-settled written call option (and similarly for convertible debt) that are based on the views expressed in paragraph A20 of Example 3 above:

(a) ***View 1—profit and loss*:**

The accounting rationale for recording the written call option premium (the CU1,000 in Example 6) through equity *in Entity A's financial statements*, is that Entity A is accounting for the potential issue of its *own shares* as a result of the written call option. If Entity A issued its own shares, although this would be recorded through equity in Entity A's financial statements, the transaction would give rise to a dilution gain or loss from Entity H's perspective. As explained in Example 2 above, our preferred view is that a dilution gain or loss on the issue of shares by the associate should be presented through net profit and loss. Because the recognition of the option premium (the CU1,000 recognised in Entity A's equity) represents a part of a share issue by the associate, proponents of this view think that this part of a possible share issue should also be presented through net profit. When the option is exercised or lapses, the impact of that part of the transaction would similarly be presented through net profit.

(b) ***View 2—OCI if two-step process is followed*:**

Similarly to the rationale in View 1 above, proponents of this view believe that the overall impact of the transaction, ie the written call option plus the impact of the option being exercised or lapsing, should be recognised through net profit. However, because the overall impact of the transaction is split into two parts if the two-step process is followed, proponents of this view do not think that it provides useful information to present only one half of the transaction in net profit when there is a related step to the transaction that will still occur – this rationale is analogous to that applied in cash flow hedge accounting. Consequently, the presentation of the change in the associate's carrying amount for the written put option is recognised initially through OCI.

When the second part of the transaction occurs (ie, the option is exercised or lapses) the portion initially recognised through OCI is recycled through net profit. Proponents of View 2 think that the overall impact of what is a single transaction is presented in net profit once the final outcome of the transaction is known, ie

(i) either a dilution gain or loss on an associate share buy-back; or

(ii) a net gain on writing a put option that is not exercised.

(c) ***View 3—equity*:**

Proponents of this view think that the net asset changes should be presented in equity because:

(i) IAS 28 paragraph 26 explains 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. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate or a joint venture.

Because the principles in IFRS 10 paragraph 23 explain that transactions with non-controlling shareholders should be accounted for through equity, then if these consolidation principles are applied for equity accounting, the accounting treatment followed by Entity A should be carried forward into the equity accounting of Entity H; and

(ii) before the consequential amendment to IAS 28, the wording in IAS 28 was clear that changes in the net assets of the associate that were not recognised through net profit in the associate should be recognised through equity in the investor (refer to paragraph A7 of Appendix A to this paper). The Basis for Conclusions of IAS 1 and IAS 28 make no mention of an intended change to the equity method as a result of the 2007 amendments to IAS 1. Consequently, requiring Entity H to recognise all of the changes as a result of the written put option and its subsequent exercise or lapse in equity would maintain the previous accounting requirements. In other words, the investor should mirror the associate's presentation of all of the changes in the net assets of the associate.

A43. We think that each of the views expressed above have relative benefits and disadvantages and that either the profit and loss (View 1) or the equity (View 3) approach could be justified under the current guidance.

A44. We do not think that the two-step process through OCI (View 2) is an appropriate approach. We think that there are two separate transactions from the investor's perspective: the first transaction is the gain from the receipt of an option premium and the second transaction is the issue of additional shares (if the option is exercised) and the resulting dilution gain or loss. In addition, we think that recognition of items in OCI is an exception to the general presentation requirements for items in the statement of comprehensive income and should be avoided where possible. Paragraph 88 of IAS 1 states that:

> An entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise.

A45. We think that for the purposes of this example only, the most appropriate accounting treatment is for the investor (Entity H) to recognise the change in other net assets through profit and loss (View 1) as explained above. For this Example 5 fact pattern, Entity H would therefore:

(a) initially record the increase in its net investment in Entity A through net profit and loss when the portion of the convertible bond that represents a written call option is issued (CU1,000 x 30 per cent).

(b) When the option is exercised, Entity H would determine the gain or loss on what is, in substance, a deemed disposal (ie a gain of CU250) through net profit and loss.

A46. We think that this is the most appropriate treatment in this example because:

(a) we think that the dilution gain or loss on a direct disposal of a portion of an associate should be presented in net profit or loss, and so we think that that the impact of a written call option (either free-standing or embedded in a convertible debt instrument) should similarly be recognised through net profit or loss;

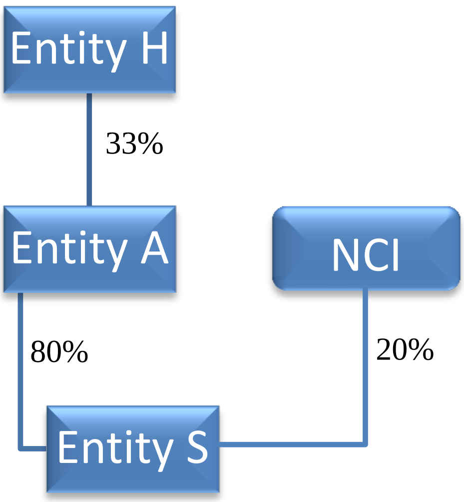
(b) unlike a 'normal' share issue by the associate, a gross-settled written call option splits the accounting into two parts. At the time that Entity A writes the call option, Entity A's net assets increase. Assuming that the equity method is a valuation technique, we think that the default position to record this increase is through profit and loss. If the option is exercised, Entity H accounts for the dilution gain or loss in a manner similar to that described in Example 1, when the associate issues additional shares to parties other than the investor.

A47. We note that the way in which we have analysed this Example 5 differs slightly from that of Example 3 (associate issues a written put option). In Example 3, we analysed the issue of the written put as the acquisition of a possible additional acquisition by the investor in concluding that the zero cost acquisition approach was preferable, whereas in this Example 5 we concluded that the dilution gain or loss is only recognised if the call option is exercised. We think that this makes sense because, for the written put option in Example 3, a liability is recognised in the associate for the possible future acquisition *at the date* that the put option is written, whereas for the written call option the issue of the new shares is only accounted for in the associate if the option is exercised.

Example 6: Associate sells stake in its subsidiary to its non-controlling shareholders

A48. Entity H is the investor in an associate, Entity A. At 1/1/20X2:

- Entity H owns 33 per cent of Entity A and Entity H's investment in Associate A is a carrying amount of CU15,000;
- Entity A's net assets are CU45,000;
- Entity A controls a subsidiary, Entity S, in which it holds 80 per cent of the ordinary shares with the remaining 20 per cent of Entity S's ordinary shares being held by non-controlling interests unrelated to Entity H as illustrated in the diagram below:



- Entity A disposes of 10 per cent of its holding in Entity S for CU10,000, and so the NCI increases to 30 per cent. In accordance with IAS 27 paragraph 31 (or IFRS 10 paragraph 23), Entity A recognises a 'credit' through equity of CU3,000 on the sale of its 10 per cent share of Entity S.
- In other words, from Entity A's *shareholders'* perspective, they have made a 'gain' on the transaction because they have exchanged their share of net assets worth CU7,000 in the Entity A group for cash of CU10,000.
- As a result of Entity A's disposal of the 10 per cent stake in its subsidiary, Entity H's claim on the carrying amount of Entity A's net assets increases by CU1,000 (CU3,000 x 33 per cent).

Analysis of the transaction

A49. Entity H's investment is in the Entity A *group*. In other words, when Entity H equity accounts for its share of the comprehensive income of Entity A, it is the consolidated Entity A's share of the group that is used as the basis for the equity accounting.

A50. From the consolidated Entity A group perspective, the equity of its subsidiary, Entity S, is considered to be equity of the group. Consequently, we think that the sale of the interest in Entity S to the NCI is economically the same as Entity A issuing its own equity into the market for cash. As explained in Example 1, we think that a share issue by an associate represents a deemed disposal. Furthermore, we concluded in Example 1 that the change in net assets as a result of a deemed disposal should be recognised in net profit and loss by the investor.

A51. Consequently, we think that in this Example 6, the resulting 'credit' of CU3,000 should be recognised in net profit and loss of Entity H.

Purchase of an NCI

A52. Although we did not address it in this example, we think that if an associate purchases an additional stake in a subsidiary from its NCI, then this is economically the same as the associate repurchasing a portion of its own equity.

A53. As explained in Example 2, we think that a share buy-back by an associate represents a deemed incremental acquisition. Furthermore, we concluded in Example 2 that the change in net assets as a result of a deemed incremental acquisition should be recognised at cost, with no net impact upon the carrying amount of the investment in the investor's financial statements.

Appendix B—Extract of agenda paper 14 from May 2011 IFRS IC meeting

Introduction

B1. 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.

B2. 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

B3. 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)

B4. 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.

B5. 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.**

B6 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:

d. *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**’

e. *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)

B7 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~~ <u>other comprehensive income</u>.** 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~~ <u>other comprehensive income</u> of the investor** (see IAS 1 Presentation of Financial Statements (as revised in 2007)).

B8 Consequently, in the description of the equity method in paragraph 11:

f. 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

g. the reference to ‘The investor’s share of those changes is recognised directly in <u>equity</u> 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

B9 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:

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

i. gains and losses arising on an associate’s transactions with non-controlling interest of its subsidiaries; and

j. liabilities recognised in respect of put options to non-controlling interests.

B10 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:

k. equity; or

l. OCI; or

m. profit or loss; or,

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

B11 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*].

B12 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.

B13 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.

B14 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).