STAFF PAPER

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Project	**IAS 28 *Investments in Associates and Joint Ventures – ADDENDUM TO AGENDA PAPER 6***
Paper topic	Application of the equity method when an associate's equity changes outside of comprehensive income

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Introduction

1. This paper is an addendum to Agenda paper 6 from the January 2012 IFRS Interpretations Committee Meeting.
2. Subsequently to publishing Agenda paper 6 on the IASB website, we received informal feedback regarding two of the calculations in the worked examples in the Appendix to Agenda paper 6.
3. The two examples in question, Example 1 and Example 5, illustrated fact patterns of a partial disposal and deemed partial disposal of an associate respectively.
4. In the examples, we tried to illustrate the gain or loss on disposal to the investor by comparing what the investor gave up and what they received as a result of the disposal. We determined this amount by comparing:

   (a) the investor's share of the carrying amount of the ***net assets of the associate*** that were lost as a result of the disposal; and

   (b) the investors share of the carrying amount of consideration that was received from the disposal.

5. The submitter of the informal feedback stated that they think that the calculation should have been determined by comparing:

(a) the investor's share of the carrying amount of the ***investment in the associate*** that was lost as a result of the disposal; and

(b) the investors share of the carrying amount of consideration that was received from the disposal.

6. We agree with the feedback received. Consequently:

(a) In Example 1, the net impact to Entity H is that their share in Entity A has increased by **CU1,636** (and not CU1,650) as a result of the share issue by Entity A; and

(b) In Example 5, if the option that was issued by Entity A is exercised, Entity H would determine the gain or loss on what is, in substance, a deemed disposal and that net gain or loss would be **zero** (and not CU250)

7. We have included as an Appendix to this addendum the relevant paragraphs from Agenda Paper 6 that would need to be amended to take the above corrections into account.

8. We do not think that the calculation amendments affect any of our rationale in the paper and therefore all of our recommendations in Agenda Paper 6 remain unchanged.

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[1];
- 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 **CU1,364 (3/33 x CU15,000)** ~~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 **CU1,636** ~~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 **CU1,636**~~CU1,650~~, because…

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

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 **CU1,636**~~CU1,650~~ when comparing the cost of its investment in Entity A to the change in the net assets of the associate…

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 **CU2,500 (5/30 x CU15,000)** ~~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 **zero** ~~CU250~~ as a result of the debt conversion **(the fact that the amount is zero is as a result of the amounts used in the example, normally there will be an impact to the investor's carrying amount of the investment)**…

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 zero net gain in this case** ~~a gain of CU250~~) through net profit and loss.