STAFF PAPER

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IASB Meeting

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

1. In June 2012, the IASB discussed an amendment to IAS 28 proposed by the IFRS Interpretations Committee (the Committee). The aim of the proposed amendment is to give guidance on whether and where an investor should account for its share of the changes in the net assets of the associate that are not recognised in profit or loss or other comprehensive income of the associate (ie, 'other net asset changes').

2. Several IASB members disagreed with the proposed amendment because it would not address all types of other net asset changes that might occur in practice, in particular share-based payments in an associate. In addition, several members were concerned that the proposed accounting did not provide symmetry between a reduction and an increase in the investor's share ownership interest in the associate and thus it would cause complexity.

3. Consequently, the IASB preferred a simpler approach that would address all types of other net asset changes. The IASB noted three views for where an investor could recognise such changes: investor's equity, investor's OCI or investor's profit or loss. In order to decide which presentation would be preferable, the IASB asked the staff to bring back a paper analysing the views to the next meeting.

4. This agenda paper is organised as follows:

    (a) Rationale for each view (paragraphs 6-22)

(b) Staff analysis and recommendation (paragraphs 23-29)

(c) Appendix A—Consideration by fact pattern

5. In this paper, we call an associate/joint venture as 'associate' collectively. **This paper only covers accounting for other net asset changes of an associate and we do not intend for the proposed amendment to change the equity method accounting for other circumstances.** In addition, this paper assumes that the investment in an associate is in the scope of IAS 28 both before and after the transaction.

Rationale for each view

View 1: Recognise share of associate's other net asset changes <u>in Investor's equity</u>

6. This approach provides a degree of symmetry by recognising the other net asset changes in the same part of the investor's financial statement as it is recognised in the associate's financial statements. This approach is also consistent with the 'one-line consolidation' perspective, which was referred to by some IASB members at the June meeting.

7. Those IASB members indicated that when IAS 28 was developed, it took as its starting point APB Opinion No. 18 'The Equity Method of Accounting for Investments in Common Stock' issued in March 1971. Opinion No.18 indicated that the objective of the equity method was to get the same result as if you consolidated an associate.

> APB Opinion No. 18 paragraph 19 (emphasis added):
>
> (…) The difference between consolidation and the equity method lies in the details reported in the financial statements. (…) The procedures set forth below should be followed by an investor in applying the equity method of accounting to investments in common stock of unconsolidated subsidiaries, corporate joint ventures, and other investees which qualify for the equity method:

a. Intercompany profits and losses should be eliminated until realized by the investor or investee as if a subsidiary, corporate joint venture or investee company were consolidated.

b. A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary. (…)

e. A transaction of an investee of a capital nature that affects the investor's share of stockholders' equity of the investee should be accounted for as if the investee were a consolidated subsidiary.

8. Although APB Opinion No. 18 has been largely replaced by Topic 323 through the Codification, the same concept still remains as follows (emphasis added):

> 323-10-35-8: Because the equity method is a one-line consolidation, the details reported in the investor's financial statements under the equity method will not be the same as would be reported in consolidated financial statements under Subtopic 810-10. (…)
>
> 323-10-35-13: A difference between the cost of an investment and the amount of underlying equity in net assets of an investee shall be accounted for as if the investee were a consolidated subsidiary. (…)

9. It is apparent that IAS 28 has the same origin from the reading of paragraph 26 (emphasis added):

> 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.

10. In addition, before the consequential amendment to IAS 28 as a result of the revision to IAS 1 *Presentation of Financial Statements* in 2007 was made, IAS 28 required that the investor's share of changes in the investee's equity be recognised in the investor's equity. On the other hand, the current wording of IAS 28 is unclear whether and where the investor should account for the investee's other net asset changes. If that was an unintended oversight in the process of the

consequential amendment, equity might be the best place to recognise such changes because doing so would keep the original requirement of IAS 28.

View 2: Recognise share of associate's other net asset changes in Investor's OCI

11. IAS 1 precludes the associate's other net asset changes from being regarded as 'owners transactions' from an investor's perspective and therefore prevents them being presented within equity. This is because an associate is not part of the consolidated group as defined in IAS 27 *Consolidated and Separate Financial Statements* (or IFRS 10 *Consolidated Financial Statements*). The transactions with the associate's equity owners are not transactions with the group's equity owners (unless they are transactions with investors within the group).

12. Paragraph 10 of IAS 28 requires that the investor's share of the investee's profit or loss is recognised in the investor's profit or loss. Including the investor's share of the associate's equity transactions in profit or loss risks giving a misleading representation of the associate's performance, since equity transactions do not reflect performance. This therefore removes the choice of an associate's other net asset changes being recognised in the investor's profit or loss.

13. Consequently, the associate's other net asset changes could be recognised in the investor's OCI in its financial statements.

View 3: Recognise share of associate's other net asset changes in Investor's profit or loss

14. This approach is consistent with the view that the equity method is the basis of measurement of a financial asset investment supported by the reasons below.

15. Changes in the measurement of a financial asset are recognised in profit or loss (with limited exceptions when certain financial assets are measured at fair value through OCI).

16. The IASB has taken decisions in recent years that are consistent with the notion that the equity method is a basis of measurement for a financial asset investment. When annual improvements associated with scope exemptions were made in 2009

to IAS 39 *Financial Instruments: Recognition and Measurement*, the basis for conclusions BC24D described the equity method as an acquisition of a financial asset (emphasis added):

> (…) However, <u>the acquisition of an interest in an associate represents the acquisition of a financial instrument</u>. The acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent net assets. The Board noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures. (…)

17. In addition, changes in an investor's equity should only reflect changes in the investor's equity. Changes in the associate's equity are not changes in the investor's equity because the associate is not part of the investor's group.

18. Consequently, the investor's share of associate's other net asset changes should be recognised in profit or loss.

Other considerations

19. In analysing the alternative views we have considered whether there would be any unintended consequences. In doing so we have considered the guidance in paragraph 25 of IAS 28. We note that, regardless of which view the IASB favours, the paragraph should be considered for the equity accounting associated with other net asset changes.

20. Paragraph 25 of IAS 28 specifies the accounting for reductions in ownership interest in an associate:

> If an entity's ownership interest in an associate or a joint venture is reduced, but the entity continues to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be

reclassified to profit or loss on the disposal of the related assets or liabilities.

21. That paragraph requires that gain or loss recognised in OCI must be reclassified to profit or loss when an investor's ownership interest reduces. In addition, 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, whether directly or indirectly, require recognition through profit or loss (emphasis added):

> The IFRIC noted that paragraph 19A[1] 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 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. <u>Paragraph 19A of IAS 28 applies to all reductions in the investor's ownership interest, no matter the cause.</u>

22. We think that the guidance in paragraph 25 of IAS 28 must be applied when there are reductions in the investor's ownership interest. Our assessment is that application of this requirement is supplemental to the accounting set out in each of the three views and compatible with them. We therefore conclude that there are no unintended consequences arising from applying any of the three views.

Staff analysis and recommendation

23. In Appendix A to this paper, we have considered each view toward examples in the form of a table, which shows journal entries we think would be appropriate.

[1] 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).

24. Considering the concerns raised by the IASB at its June meeting, we think that it is important that the solution is straight-forward yet comprehensive. We think all views would meet the criteria because they have consistent principles that can be applied to all examples considered. Consequently, we consider the views from different aspects in the following paragraphs.

25. With regard to View 2 *'investor's OCI'*, we note that the Committee universally rejected the argument that the list of OCI in paragraph 7 of IAS 1 is not considered to be exhaustive, when we first presented this issue in May 2011. In addition, the Conceptual Framework is the top priority for the IASB's future projects and one of the phases will deal with presentation including OCI. It would not be a good idea to add another OCI item at this time and we therefore do not support View 2.

26. We see some valid arguments for View 3 *'investor's profit or loss'*. However, we can also observe that recognising these other net asset changes in profit or loss can cause anomalous results; for example share-based payments: the 'debit' part of the associate's transaction is already included in the investor's share of associate's profit, so to record the investor's share of the 'credit' part of the transaction in profit as well, will result in a net nil impact on the investor's profit, which does not make sense.

27. IAS 28 requires that the investor's share of the investee's profit or loss is recognised in the investor's profit or loss. It also requires that the investor's share of the investee's OCI is recognised in the investor's OCI. Other net asset changes of an associate are changes in the associate's equity. We therefore think it is natural and intuitive that the change in the investor's share over the associate's other net asset changes are recognised in the investor's equity.

28. We acknowledge that any amendment made at this time is a short-term solution to address diversity in practice. At the May 2012 IASB meeting, the IASB supported adding a project on the 'equity method of accounting' as one of the research activities as part of the IASB's future agenda. If the recommended solution is consistent with this being a short-term solution and intended to address diversity with a straight-forward solution, we should not introduce a significant

change to practice because it would be confusing for constituents. IAS 28 prior to the revision in 2011 required that the investor's share of changes in the investee's equity be recognised in the investor's equity.

29. Consequently, we think View 1 *'investor's equity'* would be most appropriate.

Question for the IASB

Question for the IASB
Does the IASB agree with the staff recommendation on where an investor should account for its share of the changes in the associate's other net assets? If the IASB agrees with the staff recommendation, does the IASB agree that: (1) it should amend IAS 28 as a separate exposure draft rather than as part of annual improvements, because the amendments would affect the principle of equity method? (2) no additional amendment to IFRS 1 is required because the business combinations exemption already applies to investments in associates/joint ventures at date of transition? (3) the amendments should apply retrospectively? (4) the comment period should be no less than 120 days?

Appendix A—Consideration by fact patterns

These examples are examples we presented at the June 2012 IASB meeting (see Agenda Paper 11B and 11C). The prerequisite for this exercise is that an investor should account for an increase or decrease, whether directly or indirectly, in its share ownership interest in the associate.

Example	Consequences	Associate's entry	**View 1: Investor's equity**	**View 2: Investor's OCI**	**View 3: Investor's profit or loss**
(1) Associate issues additional share capital to other shareholders for cash	Investor's shareholding **percentage in the associate decreases**	Dr Cash Cr Equity	Dr Investment in associate Cr Equity *To reflect the investor's share of the associate's transaction*	Dr Investment in associate Cr OCI *To reflect the investor's share of the associate's transaction*	Dr Investment in associate Cr Profit or loss *To reflect the investor's share of the associate's transaction*
			Dr Equity Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*	Dr OCI Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*	Dr Profit or loss Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*

Example	**Consequences**	**Associate's entry**	**View 1: Investor's equity**	**View 2: Investor's OCI**	**View 3: Investor's profit or loss**
(2) Associate share buy-back from other shareholders	Investor's shareholding **percentage in the associate increases**	Dr Equity Cr Cash	Dr Equity Cr Investment in associate *To reflect the investor's share of the associate's transaction*	Dr OCI Cr Investment in associate *To reflect the investor's share of the associate's transaction*	Dr Profit or loss Cr Investment in associate *To reflect the investor's share of the associate's transaction*
			Dr Investment in associate Cr Equity *To reflect the change in the investor's shareholding percentage in the associate*	Dr Investment in associate Cr OCI *To reflect the change in the investor's shareholding percentage in the associate*	Dr Investment in associate Cr Profit or loss *To reflect the change in the investor's shareholding percentage in the associate*

Example	**Consequences**	**Associate's entry**	**View 1: Investor's equity**	**View 2: Investor's OCI**	**View 3: Investor's profit or loss**
(3) Associates writes a put option over associate's own equity to other shareholders	Investor's shareholding **percentage in the associate increases when exercised** (the put option is a potential buy-back of its shares by the associate)	[When written] Dr Equity Cr Liability	[When written] Dr Equity Cr Investment in associate *To reflect the investor's share of the associate's transaction*	[When written] Dr OCI Cr Investment in associate *To reflect the investor's share of the associate's transaction*	[When written] Dr Profit or loss Cr Investment in associate *To reflect the investor's share of the associate's transaction*
		[When exercised] Dr Liability Cr Cash	[When exercised] Dr Investment in associate Cr Equity *To reflect the change in the investor's shareholding percentage in the associate*	[When exercised] Dr Investment in associate Cr OCI *To reflect the change in the investor's shareholding percentage in the associate*	[When exercised] Dr Investment in associate Cr Profit or loss *To reflect the change in the investor's shareholding percentage in the associate*
		[When lapsed] Dr Liability Cr Equity	[When lapsed] Dr Investment in associate Cr Equity *To reflect the investor's share of the associate's transaction*	[When lapsed] Dr Investment in associate Cr OCI *To reflect the investor's share of the associate's transaction*	[When lapsed] Dr Investment in associate Cr Profit or loss *To reflect the investor's share of the associate's transaction*

Example	Consequences	Associate's entry	**View 1: Investor's equity**	**View 2: Investor's OCI**	**View 3: Investor's profit or loss**
(4) Associate sells stake in its subsidiary to its NCI for cash	Associate's equity increases for the difference between cash received and classification to NCI. There is **no change in the percentage ownership** of the associate itself.	Dr Cash Cr NCI Cr Equity (*) (* difference between the above two amounts)	Dr Investment in associate Cr Equity *To reflect the investor's share of the associate's transaction*	Dr Investment in associate Cr OCI *To reflect the investor's share of the associate's transaction*	Dr Investment in associate Cr Profit or loss *To reflect the investor's share of the associate's transaction*

Example	Consequences	Associate's entry	View 1: Investor's equity	View 2: Investor's OCI	View 3: Investor's profit or loss
(5) Associate grants its employees an equity-settled share-based payment	Associate recognises an expense with a corresponding increase in its equity over the vesting period. Investor's shareholding **percentage in the associate decreases when exercised.**	[When granted] No entry	[When granted] No entry	[When granted] No entry	[When granted] No entry
		[Vesting period] Dr SBP expense Cr Equity	[Vesting period][2] Dr Investment in associate Cr Equity *To reflect the investor's share of the associate's transaction*	[Vesting period][2] Dr Investment in associate Cr OCI *To reflect the investor's share of the associate's transaction*	[Vesting period][2] Dr Investment in associate Cr Profit or loss *To reflect the investor's share of the associate's transaction*

[2] As part of regular equity accounting, the following entry will be made for all views: Dr Income from associate, Cr Investment in associate

		[When exercised] Dr Cash Cr Equity	[When exercised] Dr Investment in associate Cr Equity *To reflect the investor's share of the associate's transaction*	[When exercised] Dr Investment in associate Cr OCI *To reflect the investor's share of the associate's transaction*	[When exercised] Dr Investment in associate Cr Profit or loss *To reflect the investor's share of the associate's transaction*
			Dr Equity Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*	Dr OCI Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*	Dr Profit or loss Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*
		[When lapsed] Dr Equity Cr Equity (reclassify within equity)	[When lapsed] No entry	[When lapsed] No entry	[When lapsed] No entry

Example	Consequences	Associate's entry	**View 1: Investor's equity**	**View 2: Investor's OCI**	**View 3: Investor's profit or loss**
(6) Associate debt is converted into equity	Investor's shareholding **percentage in the associate decreases**	Dr Liability Cr Equity	Dr Investment in associate Cr Equity *To reflect the investor's share of the associate's transaction*	Dr Investment in associate Cr OCI *To reflect the investor's share of the associate's transaction*	Dr Investment in associate Cr Profit or loss *To reflect the investor's share of the associate's transaction*
			Dr Equity Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*	Dr OCI Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*	Dr Profit or loss Cr Investment in associate *To reflect the change in the investor's shareholding percentage in the associate*