STAFF PAPER

June 2012

IASB Meeting

Project	**IAS 28 Investments in Associates and Joint Ventures**
Paper topic	Analysis of two transactions that the Committee decided not to include in the scope of its amendments

CONTACT(S)	Kazuhiro Sakaguchi	ksakaguchi@ifrs.org	+44 (0)20 7246 6930
	Gary Berchowitz	gberchowitz@ifrs.org	+44 (0)20 7246 6914

Introduction

1. As already explained in Agenda Paper 11B, the Committee has decided to recommend to the Board:

   (a) that IAS 28 should be amended to incorporate the tentative decisions from its January 2012 meeting, but

   (b) not to address **equity-settled share-based payments** or **written call options** (collectively 'call option transactions') in the amendment to IAS 28.

2. This paper summarises, regarding the call option transactions, the staff recommendation and the Committee's concerns from the January and March 2012 Committee meetings.

3. This paper asks the Board if it agrees with the Committee's recommendation, taking into account the Committee's concerns on the call option transactions.

Summary of staff recommendations for call options written by associate

4. We presented potential accounting treatments for call option transactions at the January and March Committee meetings. The details of our analysis at the time is included as Appendices to this paper:

(a) Appendix A: Staff analysis and examples from the January 2012 Committee meeting for the call option transactions.

(b) Appendix B: Staff analysis and examples from the March 2012 Committee meeting for the call option transactions.

5. We have summarised the outcome of the Committee discussions from those meetings in the table below.

Meeting	Staff recommendation	Reason for Committee rejecting proposal
January	Example 1: associate recognises an equity settled share-based payment ▪ We recommended that Entity H recognise its shares of the share-based payment expense and 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 record a nil net expense for its share of Entity A's equity-settled share-based payment (a net approach). ▪ The impact of the share-based payment would be recognised when, or if, the employees' awards vest and exercised 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)	For example 1, the Committee disagreed with a nil net expense. It thought that expenses recognised by the investee should not be ignored. That is, the investor should equity account its shares of the annual share-based payment expense recognised by the investee.

	Example 2: associate debt is converted into equity ▪ We recommended that Entity H recognise the change in Entity A's net assets through profit and loss. Entity H would therefore initially record the increase in its net investment in Entity A through profit or loss when the portion of the convertible bond that represents a written call option is issued. ▪ When the option is exercised, Entity H would determine the gain or loss on what is, in substance, a deemed disposal through profit or loss.	For example 2, an investor initially records the increase in its net investment in the associate through net profit and loss. If the call option is in deep in the money, the consequence is that an investor will recognise gain initially and loss in a later period if all options are expected to be exercised. The Committee was concerned that this might provide opportunities for structuring.
March	Example 1: associate issues share options for an item of PP&E ▪ We recommended that Entity H recognise share of changes in net assets through equity – with implicit recycling. Entity H would recognise its share of the change in net assets of Entity A through equity when the options are initially issued. ▪ When the share options are exercised, the resulting dilution loss would be recognised through net profit in Entity H by comparing what is given up at the date of the dilution and what was gained when the options were issued.	Although many of the Committee members agreed with the staff analysis, there was a concern that the staff proposal to address call options in both of the examples was too complicated. A minority of Committee members noted that the investor's economic position will not change until dilution occurs and therefore it is not

	Example 2: associate issues share options for employee services ▪ We recommended that Entity H recognise share of changes in net assets through equity – with implicit recycling. Entity H would equity account its share of the share-based payment expense of Entity A during the vesting period. At the same time, Entity H would recognise the increase in resources that Entity A obtains as a result of the share-based payment in equity of Entity H. ▪ When the share options are exercised, the resulting dilution loss would be recognised through profit or loss in Entity H by comparing the book value of what is given up at the date of the dilution and what was gained when the options were issued.	appropriate to account for the change in the investor's ownership interest until then. Further, equity recognised on day 1 belongs to the purchaser, not the investor. They used the example of a perpetual preference share that is classified as an equity instrument as an example of why they disagreed with the staff proposal. That is, if cash came into Entity A and the staff recommendation was applied, Entity H would record gain through profit or loss but economically will never realise the gain because the holder of the perpetual preference share would receive benefits from Entity A equal to the cash injected into Entity A.

7. Consequently, the Committee has tentatively decided not to recommend addressing the call option transactions in the amendment to IAS 28.

Question for the Board

Question for the Board
Does the Board agree with the Committee's recommendation?

Appendix A—Staff analysis and examples at January 2012 Committee meeting

The following two examples illustrate potential accounting treatments for call option transactions presented at the January 2012 Committee meetings.

Example 1: Associate recognises an equity settled share-based payment

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;
- 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

A2. 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 record a nil net 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 exercise 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).

A3. 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 2: Associate debt is converted into equity

A4. 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.

A5. 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

A6. 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).
- Entity H is no longer exposed to its share of the future outflow from the liability—a 'gain' of CU2,500.

A7. The net impact upon Entity H is that its share in Entity A has increased by zero 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).

A8. 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.

A9. 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?

A10. 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).

A11. We think that there are similarities in this fact pattern to the one in *Example 3 Written put option over associate's own equity* (see Appendix A to Agenda Paper 11B). In that example, 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.

A12. 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).

A13. 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?

A14. At the date that the associate writes the call option, it should receive an option premium (in this Example 2, 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.

A15. We think that the rationale in accounting for this type of transaction is similar to the one described in *Example 3 Written put option over associate's own equity* (hereinafter '*Example 3*', see Appendix A to Agenda Paper 11B): ie, the associate writes a put option on its own equity that if exercised must be settled gross. When we analysed that example, 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) of *Example 3*). 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.

A16. 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 1 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.

A17. 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*:

(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.

A18. 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.

A19. 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.

A20. 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's fact pattern, Entity H would therefore:

(d) 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).

(e) 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) through net profit and loss.

A21. We think that this is the most appropriate treatment in this example because:

(f) 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;

(g) 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.

A22. We note that the way in which we have analysed this example 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 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.

Appendix B—Staff analysis and examples from March 2012 Committee meeting

The following two examples illustrate potential accounting treatments for call option transactions presented at the March 2012 Committee meetings.

Example 1: Associate issues share options for an item of PP&E

B1. 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 CU17,000;
- Entity A's net assets are CU45,000;
- Entity A enters into a share-based payment whereby Entity A issues share options with a strike price of zero to an unrelated third party in order to acquire a new item of property, plant and equipment. The fair value of the PP&E is CU2,000. The call options cannot be net settled.

B2. The options have a fixed exercise date in five years' time. The PP&E is depreciated to zero over its five year useful life.

B3. At the end of the five year period, the options are exercised resulting in Entity H's share ownership being diluted down to 30 per cent. Entity H's investment in associate A is a carrying amount of CU27,000 at the time when the options are exercised.

Analysis of the transaction

B4. Entity A has written a call option that cannot be net settled in exchange for goods. The arrangement is therefore an equity settled share-based payment.

B5. In this example, there is an increase of CU2,000 in the net assets of Entity A at 1/1/20X2 when it obtains the PP&E in exchange for the share-based payment.

B6. During the period until the options can be exercised, Entity A will recognise an annual expense of CU400 (CU2,000 over five years) as a result of the depreciation on the PP&E. Entity H will recognise its share of this expense when it applies the equity method (CU132).

B7. When the options are exercised at the end of year five, this would represent an indirect disposal by Entity H of a share of its investment in Entity A as its shareholding drops from 33 per cent to 30 per cent.

Alternative views

B8. We think that the alternative views are:

(a) **View A – No accounting until dilution:** Under View A, the investor (ie Entity H) would recognise nothing for the issue of the share options when they are initially issued at 1/1/20X2 because this is an "other net asset change" of the associate but it is not a disposal or acquisition. When the share options are exercised, the resulting dilution loss, calculated as the difference between what is given up (ie 3 per cent of the investment in associate A) and what is received *at the time of the dilution* (ie nothing), would be recognised through net profit in Entity H, ie a loss of CU2,455 (3% ÷ 33% × CU27,000). The journal entries in Entity H would be as follows:

Dr income from associate	CU132	
Cr Investment in associate A		CU132

31/12/20X2 – 31/12/20X6 recognition of investor H's share of the depreciation of the PP&E that was acquired

Dr loss from associate A	CU2,455	
Cr investment in associate A		CU2,455

1/1/20X7 recognition of dilution loss of 3 per cent of investment

(b) **View B – Recognise share of changes in net assets through net income:** Under View B, Entity H would recognise its share of the change in the net assets of Entity A when the options are issued as part of its share of the income from the associate, ie CU660 (CU2,000 × 33%) through net profit on 1/1/20X2. When the share options are exercised, the resulting dilution loss would be recognised through net profit in Entity H, ie a dilution loss of CU2,455. The rationale being that a written call option is linked to a possible dilution, the associate has just split the issuance of the shares (and hence the dilution gain/loss) into its two constituent transactions. These two parts of the overall transaction are reported in the financial statements in the period in which the corresponding change in net assets occurs. The journal entries in Entity H would be as follows:

Dr investment in associate A CU660

Cr income from associate A CU660

1/1/20X2 recognition of investor H's share of the item of PP&E that was acquired - recognised through net income

Dr income from associate CU132

Cr investment in associate A CU132

31/12/20X2 – 31/12/20X6 recognition of investor H's share of the depreciation of the PP&E that was acquired

Dr loss from associate A CU2,455

Cr investment in associate A CU2,455

1/1/20X7 recognition of dilution loss of 3 per cent of investment when options are exercised and dilution of shareholding occurs for investor H

(c) **View C – Recognise share of changes in net assets through equity – no recycling:** Under View C, Entity H would recognise its share of the change in net assets of Entity A through equity when the options are initially issued. In other words, at the date that the PP&E is acquired, Entity H would increase the carrying amount of its investment in Entity A by CU660 (CU2,000 × 33%) with a corresponding increase in its statement of changes in equity. When the share options are exercised, the resulting dilution loss would be recognised through net profit in Entity H, ie CU2,455. The rationale being that:

(i) the equity method requires all other net asset changes to be recognised in the investor's statement of financial position; but

(ii) when the share options are issued, the other net asset changes are not a disposal or acquisition, therefore the presentation should follow that used in the associates financial statements, ie presented in the statement of changes in equity; and

(iii) when the dilution actually occurs, this is treated in the same way as any partial disposal, by comparing what was given up (ie, the 3% share ownership lost) by what was gained *at the time of the indirect disposal* (ie, zero).

The journal entries would be as follows:

Dr investment in associate A	CU660		
	Cr equity		CU660

1/1/20X2 recognition of investor H's share of the item of PP&E that was obtained - recognised in H's statement of changes in equity

Dr income from associate	CU132		
	Cr investment in associate A		CU132

31/12/20X2 – 31/12/20X6 recognition of investor H's share of the depreciation of the PP&E that was acquired

Dr loss from associate A	CU2,455		
	Cr investment in associate A		CU2,455

1/1/20X7 recognition of dilution loss of 3 per cent of investment when options are exercised and dilution of shareholding occurs for investor H

(d) **View D – Recognise share of changes in net assets through equity – with implicit recycling:** Under View D, the accounting and rationale is the same as View C, ie when the share options are exercised, the resulting dilution loss would be recognised through net profit in Entity H by comparing:

(i) what is given up at the date of the dilution, ie 3 per cent of the carrying amount of the associate – CU2,455); however, view D then compares this amount with

(ii) what was gained *when the options were issued*, ie 33 per cent of the fair value of the asset acquired – CU660).

The rationale for the accounting treatment is similar to that in View C above, however, when calculating the net dilution gain or loss, proponents of View D think that it provides more useful information to include what was gained by the investor when the options were issued. Proponents of view D do not think that this is "explicit recycling", because the gain was never recognised in the statement of comprehensive income of the investor.

The journal entries in Entity H would be as follows:

Dr investment in associate A	CU660	
Cr equity		CU660

1/1/20X2 recognition of investor H's share of the item of PP&E that was obtained - recognised in H's statement of changes in equity

Dr income from associate	CU132	
Cr investment in associate A		CU132

31/12/20X2 – 31/12/20X6 recognition of investor H's share of the depreciation of the PP&E that was acquired

Dr loss from associate A	CU1,795	
Dr equity	CU660	
Cr investment in associate A		CU2,455

1/1/20X7 recognition of dilution loss of 3 per cent of investment when the change in shareholding occurs, taking into account the benefit that was received when the options were issued in 20X2

(e) **View E – Recognise share of changes in net assets through other comprehensive income ("OCI") with explicit recycling:** Under View E, Entity H would apply the same accounting treatment as that followed in View D, except:

(i) when the share options are issued, the change in net assets of Entity A is recognised through OCI, ie CU660; and

(ii) when the share options are exercised, the resulting dilution loss would be recognised through net profit and the initial amount recognised through OCI would be recycled through the income from associate line item in the statement of comprehensive income.

The rationale for the accounting treatment is similar to that in View D above, however, proponents of View E think that, in order to include the gain on the initial issuance of the options in the calculation of the net dilution gain or loss, the gain needs to first be recognised through OCI. Proponents of View E think that this is consistent with other gains (and losses) under IFRS that affect net profit in a period after they are initially recognised in the statement of financial position, eg derivatives in a qualifying hedging activity. The journal entries in Entity H would be as follows:

Dr investment in associate A	CU660	
Cr OCI		CU660

1/1/20X2 recognition of investor H's share of the item of PP&E that was obtained - recognised in H's other comprehensive income

Dr income from associate	CU132	
Cr investment in associate A		CU132

31/12/20X2 – 31/12/20X6 recognition of investor H's share of the depreciation of the PP&E that was acquired

Dr loss from associate A	CU1,795	
Dr OCI	CU660	
Cr investment in associate A		CU2,455

1/1/20X7 recognition of dilution loss of 3 per cent of investment when the change in shareholding occurs, and recycling of the initial gain recognised through OCI

Consideration of alternative views

B9. We do not agree with View A. We think applying View A results in Entity H never recognising the fact that its claim on the net assets of Entity A increased as a result of the PP&E that was initially obtained.

B10. We do not agree with View B. We think that recording a gain when the PP&E is first obtained is not a true representation of the economics of the arrangement from Entity H's perspective. There has been an increase in the net assets of Entity A, but the cost of obtaining those assets will only be confirmed when the share option either lapses or is exercised. We think that recognising the gain from the change in other net assets through net profit when the options are issued, only to subsequently record a dilution loss through net profit when the options are exercised, does not provide useful information to users of Entity H's financial statements. In addition, we think that applying View B would introduce structuring opportunities, as Entity H could utilise its significant influence to encourage Entity A to issue options for cash or assets in years where Entity H needed to temporarily boost profits.

B11. We do not agree with View C. We think that recognising the "gain" portion of the transaction through equity in Entity H, while recognising the dilution loss through net profit, distorts the performance statement of Entity H. The net gain or loss to Entity H as a result of Entity A entering into the transaction can only be determined by comparing what was received (ie the fair value of the PP&E of CU660) with the cost (ie the 3 per cent dilution when the options are exercised). In other words, we do not think the accounting should be different if Entity A acquired the PP&E for shares or share options; in both cases, the dilution gain or loss should be determined by comparing what was given up with what was obtained.

B12. We think that View D or View E is an appropriate alternative. We think that both View D and View E provide the more appropriate accounting because under both views:

(a) the change in the net assets of the associate is recognised in the investor's financial statements in the period in which the change *occurs*. In other words, the investor's "investment in associate" carrying amount would represent all the changes in the net assets of the associate for that period; and

(b) the net impact of the dilution, as either a gain or loss, is recognised in net profit in the period in which the dilution occurs. In other words, the investor's "income from associate" is determined in a manner consistent with other dilution gains and losses and presented in the period when the dilution occurs.

B13. We think that View D is the better of the two views because we think the accounting treatment in paragraph A12 can be achieved without introducing new items that are recognised in OCI. We do not think that introducing new items into OCI is preferable until the Board determines the principles related to OCI and recycling.

Example 2: Associate issues share options for employee services

B14. 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 enters into an equity-settled share-based payment with its employees in the form of options with a zero strike price. The grant date fair value of the award is CU2,000 and the award has only a five year service condition. The options cannot be net settled by the employees upon vesting.

B15. At the end of the five year vesting period, all of the awards vest and the employees exercise their options resulting in Entity H's share ownership being diluted down to 30 per cent.

B16. Entity H's investment in associate A is a carrying amount of CU25,000 at the time when the options are exercised. This ignores the impact of the share-based payment. In other words, for the purposes of this example, Entity H's investment in associate A is a carrying amount of CU25,000 before taking into account the share-based payment. We will consider what the possible impacts of the share-based payment might be to Entity H when we consider the alternative views below.

Analysis of the transaction

B17. Entity A has written a call option that cannot be net settled in exchange for future employee services. The arrangement is therefore an equity settled share-based payment.

B18. In this example, there is no increase in the net assets of Entity A at 1/1/20X2. At the time when the share options are initially granted, Entity A has not been provided with any goods or services.

B19. Over the five year vesting period, Entity A receives the services from the employees over the vesting period which results in Entity A recognising the share-based payment expense of CU400 per year. In other words, the benefit of the employee services is received and consumed immediately by Entity A over the vesting period, and hence no asset is recognised.

B20. When the options are exercised at the end of year five, this would represent an indirect disposal by Entity H of a share of its investment in Entity A as its shareholding drops from 33 per cent to 30 per cent.

Alternative views

B21. We think that the alternative views are:

(a) **View A – No accounting until dilution:** Under View A, the investor (ie Entity H) would recognise no impact for the share-based payment in Entity A because there is no change to the net assets of Entity A during the vesting period. When the share options are exercised, the resulting dilution loss, calculated as the difference between what is given up (ie 3 per cent of Entity H's investment in Entity A) and what is received *at the time of the dilution* (ie zero), would be recognised through net profit in Entity H, ie a loss of CU2,273 (3% ÷ 33% × CU25,000). The journal entries in Entity H would be as follows:

Dr loss from associate A	CU2,273	
Cr investment in associate A		CU2,273

1/1/20X7 recognition of dilution loss of 3 per cent of investment. Share-based payment expense is ignored during the vesting period.

(b) **View B – Recognise share of share-based payment and increase in resources through net income:** Under View B, Entity H would recognise its share of the share-based payment expense of Entity A during the vesting period ie CU132 reduction in the "income from associate" per year over the five year period. However, at the same time, Entity H would recognise the increase in resources that Entity A obtains as a result of the share-based payment. In other words, the share-based payment is viewed as two separate transactions with a net result to the “income from associate” of zero:

(i) Entity A issues an equity instrument in exchange for a notional asset (representing the right to employee services), resulting in an increase in its net assets and consequently a gain for Entity H; and simultaneously

(ii) Entity A utilises the notional asset in exchange for employee services, resulting in a decrease in its net assets and consequently an expense equal to the amount of the gain.

When the share options are exercised, the resulting dilution loss would be recognised through net profit in Entity H, ie a dilution loss of CU2,273. The journal entries in Entity H would be as follows:

Dr income from associate CU132

Cr investment in associate A CU132

31/12/20X2 – 31/12/20X6 recognition of investor H’s share of the share-based payment expense over the vesting period.

Dr investment in associate A CU132

Cr income from associate CU132

31/12/20X2 – 31/12/20X6 recognition of investor H’s share of the share-based payment notional asset over the vesting period.

Dr loss from associate A CU2,273

Cr investment in associate A CU2,273

1/1/20X7 recognition of dilution loss of 3 per cent of investment when the change in shareholding occurs

(c) **View C – Recognise share of changes in net assets through equity – no recycling:** Under View C, Entity H would account for the transaction in a similar manner to that in View B above. However, the increase in resources as a result of the share-based payment is recognised in equity of Entity H, because the other net asset changes are not a disposal or acquisition, therefore the presentation should follow that used in the associate's financial statements, ie presented in the statement of changes in equity. The corresponding journal entries in Entity H would be:

Dr income from associate A	CU132	
Cr investment in associate A		CU132
Dr investment in associate A	CU132	
Cr equity		CU132

31/12/20X2 – 31/12/20X6 recognition of employee services (repeated over the 5 year vesting period).

Dr loss from associate A	CU2,273	
Cr investment in associate A		CU2,273

1/1/20X7 recognition of dilution loss of 3 per cent of investment when the change in shareholding occurs

(d) **View D – Recognise share of changes in net assets through equity – with implicit recycling:** Under View D, the accounting and rationale is the same as View C, ie when the share options are exercised, the resulting dilution loss would be recognised through net profit in Entity H by comparing:

(i) what is given up at the date of the dilution, ie 3 per cent of the carrying amount of the associate – CU2,273); however, view D then compares this amount with

(ii) what was gained *when the options were issued*, ie 33 per cent of the fair value of the service asset that was acquired – CU2,000 × 33% = CU660).

The rationale for the accounting treatment is similar to that in View C above, however, when calculating the net dilution gain or loss, proponents of View D think that it provides more useful information to include what was gained by the investor over the vesting period, ie entity H's share of the employee services with a grant date fair value of CU2,000. Proponents of view D do not think that this is explicit "recycling", because the gain was never recognised in the statement of comprehensive income of the investor.

The corresponding journal entries in Entity H would be:

Dr income from associate A	CU132	
Cr investment in associate A		CU132
Dr investment in associate A	CU132	
Cr equity		CU132

31/12/20X2 – 31/12/20X6 recognition of H's share of the employee services (repeated for 5 years) consistent with View C above.

Dr loss from associate A	CU1,613	
Dr equity	CU660	
Cr investment in associate A		CU2,273

1/1/20X7 recognition of dilution loss of 3 per cent of investment after taking into account Entity H's share of the grant date fair value of the services that were obtained in exchange for the share options.

(e) **View E – Recognise share-based payment as reduction of investment in associate carrying amount:** Under View E, Entity H recognises its share of the net profit of Entity A, which includes its share of the share-based payment. However, the "credit side" of the share-based payment in Entity A represents a dilution of Entity H's interest in the associate. Consequently, the dilution loss impacts the investment carrying amount over the period that the dilution occurs, ie the vesting period. The corresponding journal entries in Entity H would be:

Dr income from associate A CU132

Cr investment in associate A CU132

31/12/20X2 – 31/12/20X6 recognition of employee services (repeated for 5 years). From investor H's perspective, this represents a dilution loss over the vesting period

Dr loss from associate A CU2,213

Cr investment in associate A CU2,213

1/1/20X7 recognition of dilution loss of 3 per cent of investment. Calculated as (CU25,000 – CU660) × 3% ÷ 33%)

Consideration of alternative views

B22. **View A – No accounting until dilution:** We do not agree with View A. We think applying View A results in Entity H never recognising the fact that its claim on the net assets of Entity A increased as a result of the employee services that were initially obtained and then subsequently used.

B23. **View B – Recognise share of share-based payment and increase in resources through net income:** We do not agree with View B. We think that recording the portion of the transaction that represents a "gain" when the employee services are obtained is not a true representation of the economics of the arrangement from Entity H's perspective. We think that there is an increase in the net assets of Entity A for the notional employee service asset which is used over the vesting period and therefore expensed under IFRS 2, but the *cost* of obtaining the employee services from Entity H's perspective will only be confirmed when the share option either lapses or is exercised. We think that recognising the gain portion of the transaction from the change in other net assets through net profit over the vesting period, only to subsequently record a dilution loss through net profit when the options are exercised, does not provide useful information to users of Entity H's financial statements. In addition, we think that applying View B would introduce structuring opportunities, as Entity H could utilise its significant influence to encourage Entity A to pay for employee services with share options and recognise no expense for the services in years where Entity H needed to temporarily boost profits.

B24. **View C – Recognise share of changes in net assets through equity – no recycling:** We do not agree with View C. We think that recognising the "gain" portion of the transaction through equity in Entity H, while recognising the dilution loss through net profit, distorts the performance statement of Entity H. The net gain or loss to Entity H as a result of Entity A entering into the share-based payment transaction can only be determined by comparing what was received (ie Entity H's share of the grant date fair value of the employee services of CU660) with the cost (ie the 3 per cent dilution loss when the options are exercised).

B25. **View D – Recognise share of changes in net assets through equity – with implicit recycling:** We think view D is the most appropriate accounting treatment because:

(a) the change in the net assets of the associate is recognised in the investor's financial statements in the period in which the change *occurs*. In other words, the investor's "investment in associate" carrying amount would represent all the changes in the net assets of the associate for that period, both the increase as a result of issuing options for employee services and the decrease for utilising those employee services with a net zero change to the investment carrying amount; and

(b) the *net* impact of the dilution, as either a gain or loss, is recognised in net profit in the period in which the dilution occurs and recognises that the dilution was an exchange transaction in which there was not only a decrease in ownership, but also an increase based on the asset that was obtained in exchange for issuing shares. In other words, the investor's "income from associate" is determined in a manner consistent with other dilution gains and losses and the net impact of the dilution is presented in the period when the dilution occurs.

B26. **View E – Recognise share-based payment as reduction of investment in associate carrying amount:** We do not agree with View E because:

(c) during the vesting period, there is no change to the net assets of Entity A. The equity method is based on changes in the net assets of an associate. Because there is no change to the net assets of the associate during the vesting period, we do not think that the carrying amount in Entity H's statement of financial position should be adjusted for the effects of the share-based payment;

(d) there is no change in the investor's *share ownership* during the vesting period. Although the share options are equity instruments of the associate, they do not represent a change to the investor's ownership until they are exercised. Consequently, the share options should not be treated as a dilution loss unless they are exercised; and

(e) applying View E results in an overall expense of CU2,873 (CU660 + CU2,213) recognised in Entity H's statement of comprehensive income. We think this overstates the expense from the share-based payment because it double counts a portion of the share-based payment, first as an expense during the vesting period, and then again when only a 3/33 portion of the benefit from the services is taken into account when determining the dilution loss.