STAFF PAPER

March 2012

IFRS Interpretations Committee Meeting

IFRS IC meetings: May 2011, Nov 2011, Jan 2012
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

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

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 remaining aspects of this issue.

Summary of the issue to date

2. In May 2011, the IFRS Interpretations Committee ("the Committee") received a request to:

(a) correct an inconsistency between the requirements of paragraphs 2 and 11 of IAS 28 and IAS 1 *Presentation of Financial Statements (revised 2007)* regarding the description and application of the equity method. This inconsistency arose when IAS 1 made a consequential amendment to paragraph 11 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, or that are not distributions received. 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. This issue was first discussed at the May 2011 Committee meeting. 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 to recommend that this issue be considered by the Board as part of a broader project to address other issues that have been brought to the Committee's attention relating to IAS 28.

5. In September 2011, the issue was presented to the Board and the Board asked if the Committee would reconsider the issue. At its November 2011 meeting, the Committee agreed to reconsider this issue as a result of the Board's request.

6. At the January 2012 meeting, the Committee considered several fact patterns that illustrated the issue in an attempt to develop a principle that might be useful to the Board in considering whether and how to amend IAS 28.

Tentative decisions made to date

7. At the January 2012 meeting, the Committee tentatively agreed on the following principles (assuming that the investment is in the scope of IAS 28 both before and after the transaction):

   (a) where an investor's share ownership interest in the associate is reduced, whether directly or indirectly, the impact of the change should be treated as a partial disposal and recognised in profit and loss of the investor; and

   (b) where an investor's share ownership interest in the associate increases, whether directly or indirectly, the impact of the change should be accounted for as an incremental purchase of the associate and recognised at cost.

8. The Committee directed the staff to further consider the accounting by the investor in the following situations with a view to developing a principle that could be presented to the Board:

(a) written call options issued by the associate for cash or other assets; and

(b) equity settled share-based payments issued by the associate for employee services.

Example fact patterns for consideration

9. We have prepared two fact patterns based on the Committee's request from the January 2012 meeting. For each fact pattern, we have looked at possible accounting treatments in addition to those included in the January 2012 paper in an attempt to help the Committee determine the most appropriate accounting treatment in the investor's financial statements.

10. 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 share options for an item of property, plant and equipment ("PP&E"); and

    (b) Example 2: the associate enters into an equity settled share-based payment with its employees.

11. We did not specifically consider an example where the associate issues share options for cash only. We think this example would provide the same analysis as that in Example 1. In other words, we do not think there is a difference between an entity issuing a share option directly for an item of PP&E, or issuing a share option for cash and immediately thereafter using the cash to purchase an item of PP&E.

Summary of results from examples

12. The table below summarises our views regarding what we think the most appropriate accounting for each of the examples should be:

Example		Should other net asset changes be *recognised* by the investor?	Where should the other net asset changes be *presented*?
1	The associate issues share options for an item of property, plant and equipment ("PP&E") or cash.	Yes	Initially in equity, ie Dr investment in associate Cr equity Subsequently taken into account in the calculation of the dilution loss if options are exercised (implicit recycling).
2	The associate enters into an equity settled share-based payment with its employees	Yes[1].	Initially in equity, ie Dr investment in associate Cr equity Subsequently taken into account in the calculation of the dilution loss if options are exercised (implicit recycling).

Underlying principles illustrated from the examples

13. We think that the key difficulty that arises with written call options that cannot be net settled, is that the written call option splits a dilution gain or loss into its two constituent transactions. For example, when an associate issues shares (rather than

[1] In an equity-settled share-based payment, there is no change to the net assets of the associate therefore there is no change to the "other net assets" as defined in this paper. The summary table is intended to show whether we think the investor should account for the 'credit' side of the share-based payment that was recognised in equity by the associate.

options) for cash or another asset, the dilution gain or loss is calculated at the time of the share issue by comparing:

(a) what was acquired, ie the investor's share of the cash or other asset; and

(b) what was given up, ie the dilution in the carrying amount of the associate.

However, when the associate issues an option, it receives only the inflow from the transaction when the option is issued, ie (a) above. We think that in order to faithfully reflect the transaction from the investor's point of view, the impact of the inflow should only impact net profit when the impact of the outflow occurs, ie (b) above.

14. Consequently, in working through the examples, we think that there is an underlying principle that can be applied:

(a) a change in the other net assets of an associate that is not a direct or indirect disposal or acquisition is presented in the same way as the associate itself presents the transaction, ie in equity; and

(b) when a dilution gain or loss is calculated, the investor needs to take into account any related other changes in equity that may have occurred at an earlier point in time when determining what the net dilution gain or loss is. As explained above in paragraph 13, we think this will only need to be considered when an associate issues a call option that cannot be net settled.

Underlying principle for other net asset changes in an associate

15. If we combine the tentative decisions made by the Committee at the January 2012 meeting with the proposed principles in this paper, we think that the overall principle that could be applied to other net asset changes is as follows:

(a) where an investor's share ownership interest in the associate is reduced, whether directly or indirectly, the impact of the change should be recognised in profit and loss of the investor (January 2012 meeting);

(b) where an investor's share ownership interest in the associate increases, whether directly or indirectly, the impact of the change should be accounted for as an incremental purchase of the associate and should be recognised at cost (January 2012 meeting);

(c) where there is a change in the other net assets of an associate that is not a direct or indirect disposal or acquisition, the impact of the change should be recognised and presented in the same way as the associate itself presents the transaction, ie in equity; and

(d) when a dilution gain or loss is calculated, the investor needs to take into account any related other changes in equity that may have occurred at an earlier point in time when determining what the net dilution gain or loss is.

Staff recommendation

16. As explained earlier in this paper, the Board asked the Committee to reconsider this issue and recommend to the Board how it might address this issue in the short term.

17. 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.

18. We think that the Committee is now in a position to:

(a) explain to the Board why the Committee previously stated that the issue was broad;

(b) provide the Board with the Committee’s view on what the principles are that could address the issue;

(c) ask the Board whether the Board thinks it should amend IAS 28 in the short term to address the issue based on the principles developed by the Committee; and

(d) if the Board does want to amend IAS 28 to address this issue based on the Committee’s proposed principles, whether the Committee or the Board should develop the amendment.

Question for the Committee
1. Does the Committee agree with the principles as stated in paragraph 15 above? 2. Does the Committee agree with the staff recommendation to present the Committee’s recommendation to the Board as explained in paragraph 18 above?

Appendix A – illustrative examples

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

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 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.

A2. The options have a fixed exercise date in five years' time. The PP&E is depreciated to zero over its five year useful life.

A3. 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

A4. 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.

A5. 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.

A6. 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).

A7. 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

A8. 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

A9. 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.

A10. 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.

A11. 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.

A12. 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.

A13. 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

A14. 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.

A15. 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.

A16. 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

A17. 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.

A18. 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.

A19. 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.

A20. 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

A21. 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

A22. **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.

A23. **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.

A24. **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).

A25. **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.

A26. **View E – Recognise share-based payment as reduction of investment in associate carrying amount:** We do not agree with View E because:

(a) 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;

(b) 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

(c) 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.

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:

a. *total comprehensive income* is described as (emphasis added):

> 'the change in equity during a period resulting from transactions and other events, **other than those changes resulting from transactions with owners in their capacity as owners**'

b. *other comprehensive income* is described as (emphasis added):

> '[it] comprises items of income and expense (including reclassification adjustments) **that are not recognised in profit or loss as required or permitted by other IFRSs'**

Relevant literature (IAS 28)

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:

a. the reference to ‘changes in the investee’s **equity** that have not been recognised in the investee’s profit or loss’ was replaced by: ‘changes in the investee’s **other comprehensive income**; and

b. the reference to ‘The investor’s share of those changes is recognised directly in <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:

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

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

c. 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:

a. equity; or

b. OCI; or

c. profit or loss; or,

d. 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).