IFRS Accounting

Staff paper

Agenda reference: 13A

IASB® meeting

Date	**June 2023**
Project	**Equity Method**
Topic	**Towards an Exposure Draft—Transactions and other events that change an investor's ownership interest**
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Introduction and purpose of this paper

1. At its September 2022 meeting, the International Accounting Standards Board (IASB) discussed other changes in the associate's net assets that change the investor's ownership interest. Agenda Paper 13B of that meeting noted:

> The analysis in this paper does not apply to an associate's equity-settled share-based payment transactions that result in the associate issuing new shares to the counterparty and changing the investor's ownership interest.

2. The purpose of this paper is to ask the IASB whether it should develop proposals on how an investor applies the equity method when an associate issues an equity-settled share-based payment or a share warrant.

Staff recommendation

3. The staff recommend the IASB does not develop proposals on how an investor applies the equity method when an associate issues an equity-settled share-based payment or a share warrant.

Structure of this paper

4. The paper is structured as follows:

   (a) background:

      (i) description of the transactions discussed in this paper (paragraphs 5–11);

      (ii) definition of the equity method in IAS 28 *Investments in Associates and Joint Ventures* (paragraphs 12–13); and

      (iii) IASB's tentative decisions in the project (paragraphs 14–16);

   (b) staff analysis (paragraphs 17–28);

   (c) information on potential dilutive effect (paragraphs 29–33);

   (d) outreach (paragraphs 34–36);

   (e) staff conclusion and recommendation (paragraphs 37–40);

   (f) question for the IASB; and

   (g) appendix.

Background

Description of the transactions discussed in this paper

Share-based payment

5. In this paper, a share-based payment is a transaction in which an associate grants share options to its employees in exchange for their services. When the share options vest and are exercised, the associate issues shares to the employees.

6. Usually there is a period between the date the share-based payment is granted and the date the share options vest which is known as the vesting period.

7. An associate applies the requirements in IFRS 2 *Share-based Payments* to the share-based payment. Paragraph 15 of IFRS 2 requires an entity granting share-based payments to recognise an expense during the vesting period for the services received and credit a corresponding amount in equity. When the share options vest, the entity recognises a transfer from one component of equity to another.

8. As a consequence of the associate's granting a share-based payment to its employees the investor's ownership will be diluted, assuming the share-based payment is exercised. In these circumstances there is no change in the associate's net assets during the vesting period or when the shares are issued[1].

Share warrant

9. In this paper, a share warrant is a transaction in which an associate gives a third party the right to receive the associate's shares at a future date and immediately receives a premium in cash from that party. When the share warrant is exercised, an associate will issue shares and receive additional cash for the subscription price. There is a period between the date the share warrant is issued and the date when it can be exercised and the shares are issued.

10. An associate applies the requirements in IFRS 9 *Financial Instruments* and IAS 32 *Financial Instruments: Presentation* to a share warrant. When the share warrant is classified as equity in accordance with paragraph 22 of IAS 32, the entity recognises the cash received as premium when the warrant is issued and credits a corresponding amount in equity. If the share warrant expires, the associate may reclassify the premium within equity.

11. As a consequence of an associate issuing a share warrant:

    (a) at the date the share warrant is issued, the associate's net assets increase for the cash premium received; and

[1] For simplicity, we do not consider a cash-settled share-based payment, or an equity-settled share-based payment in which the employees will also pay cash to exercise their options.

(b) at the date the share warrant is exercised, the associate's net assets increase for the subscription price received and the investor's ownership is diluted.

Definition of the equity method in IAS 28

12. Paragraph 3 of IAS 28 defines the equity method as a method whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. An investor's share of the investee's net assets may change either because:

    (a) the net assets of the investee change, for example the investee's profit or loss; or

    (b) the investor's share of ownership changes.

13. Paragraph 10 of IAS 28 requires an investor to recognise its share of the investee's profit or loss in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment.

IASB's tentative decisions in this project

14. As part of this project, the IASB tentatively has decided that an investor applying the equity method:

    (a) when purchasing an additional interest in an associate while retaining significant influence, would recognise any difference between the cost of the additional interest and its additional share in the net fair value of the associate's identifiable assets and liabilities either as goodwill, or as a gain from a bargain purchase[2];

[2] See the IASB Update of the March 2023 meeting.

(b) when disposing of part of interest in an associate while retaining significant influence would measure the portion of the investment to be derecognised as a proportion of the carrying amount of the investment at the date of the disposal[3];

(c) would recognise its share of other changes in an associate's net assets that increase its ownership interest as a purchase of an additional interest[4]; and

(d) would recognise its share of other changes in an associate's net assets that decrease its ownership interest as a partial disposal[5].

15. In September 2022, the IASB tentatively decided that transactions and other events in paragraph 14(c)–(d) of this paper—such as an associate issuing or redeeming shares from an unrelated party—have economically similar outcomes to a purchase of additional interests or a partial disposal and, therefore, the reported outcomes for these transactions should be similar.

16. The table in the Appendix to this paper summarises the effects of the transactions for which either IAS 28 provides requirements or the IASB's tentative decisions in paragraph 14 of this paper will propose requirements.

Staff analysis

17. In paragraphs 18–28 of this paper, we explain why the requirements in IAS 28 and the IASB's tentative decision on changes in ownership whilst retaining significant influence are not sufficient to address other changes in an investor's ownership interest that arise from an associate's issuing a share-based payments and a share warrant.

[3] See the IASB Update of the December 2022 meeting.
[4] See the IASB Update of the September 2022 meeting.
[5] See the IASB Update of the September 2022 meeting.

Share-based payment

18. During the vesting period, a share-based payment granted by an associate is recognised in the associate's profit or loss, with no change in the associate's net assets. Applying paragraph 10 of IAS 28, an investor recognises its share of the associate's profit or loss and thereby its share of the share-based payment expense.

19. The table in the Appendix to this paper summarises the effects of the share-based payment on the associate's net assets and profit or loss and on the investor's cash.

20. The staff identified two views on how the IASB's tentative decision in paragraph 14(d) applies to a share-based payment granted by an associate:

View 1 The IASB's tentative decision would not apply during the vesting period because the investor's ownership interest has not changed yet.

The IASB's tentative decision would apply only when the share options vest and the shares are issued.

Those holding this view believe that the investor should recognise the dilution of its investment in the associate only at that moment and therefore should not recognise any amount in relation to the share-based payment during the vesting period.

View 2 The investor should recognise a dilution in its investment in the associate over the vesting period of the share-based payment.

21. A dilution loss at the date the shares are issued (View 1) would be measured as the change in the investor's share of the investee's net assets. Under View 2, there is a question on the measurement of the dilution loss over the vesting period. This is because the share-based payment expense recognised by the associate measures the services provided by the associate's employees, not the investor's dilution loss, and is measured in accordance with IFRS 2 using the fair value of the equity instruments at grant date.

22. The two amounts (the investor's dilution loss and the investor's cumulative share of the share-based payment expense recognised by the associate) are unlikely to be the same. An investor that recognises its share of the share-based expense would therefore need to adjust the cumulative expense when the shares are issued.

23. The staff think that either view would present some complexities, because:

    (a) under View 1, the transaction is deemed to affect the investor only when the shares are issued, which would require the investor to ignore the amounts recognised in the associate's financial statements (the share-based expense) until the shares are issued.

    (b) under View 2, the transaction is deemed to affect the investor from the grant date, as if the investor had directly issued its share of the instruments, which would presumably require the amounts recognised in the associate's financial statements to be adjusted to a fair value measurement, such as the measurement of cash-settled share-based payments in IFRS 2 for a share-based payment.

Share warrant

24. When an associate issues the share warrant, the cash premium received is recognised in the associate's equity and changes the associate's net assets. There is a further effect on the investor's share in the investee's net assets when the share warrant is exercised, because:

    (a) the associate receives the subscription price; and

    (b) the associate issues shares, and the investor's ownership interest is diluted.

25. The table in the Appendix to this paper summarises the effects of the share warrant on the associate's net assets and profit or loss and on the investor's cash.

26. Similar to a share-based payment, the staff also identified two views on how the IASB's tentative decision in paragraph 14(d) applies to a share warrant issued by an associate:

View 1 The IASB's tentative decision would not apply because at the date the share warrant are issued the investor's ownership interest has not changed yet.

The IASB's tentative decision would apply only when the share warrant are exercised and the shares are issued.

View 2 The investor should recognise a dilution in its investment over the period from the date the share warrant is issued until the date the share warrant is exercised and the shares are issued.

27. A dilution gain or loss at the date the shares are issued would be measured as the change in the investor's share of the investee's net assets. Under View 2, there is a question about the measurement of the dilution gain or loss during the period (from the date the warrant is issued until the date it is exercised and the shares are issued). This is because the cash premium received by the associate on issuing the warrant may not representative of the total cash that will be received on issuing the shares and cannot be a measure of the future dilution gain or loss.

28. Similar to a share-based payment, the staff think that either view would present some complexities, because:

(a) View 1 would require the investor to ignore the cash premium received by the associate on issuing the share warrant.

(b) View 2 would require developing a measurement for the dilution gain and loss over the period (from the date the share warrant is issued until the date the share warrant is exercised and the shares are issued).

Information on potential dilutive effect

29. Share-based payments and share warrants both have a potential dilutive effect on an investor's holding of an investment in an associate. If the investor's interest is diluted, then future cash flows to which the investor is entitled may change. Therefore, users will want to understand this potential dilutive effect.

30. IAS 33 *Earnings per Share* requires information on the effect of potentially dilutive instruments issued by an associate. The objective of IAS 33 is to prescribe principles for the determination and presentation of earnings per share. The focus of IAS 33 is on the denominator of the earnings per share calculation.

31. Paragraph 40 of IAS 33 requires that if an associate issues potential ordinary shares that are convertible into ordinary shares of the associate to parties other than the investor, and if these potential ordinary shares have a dilutive effect on the basic earnings per share of the investor, then the shares are included in the calculation of diluted earnings per share.

32. Paragraph 70 of IAS 33 requires disclosure of the weighted average number of ordinary shares used as the denominator in calculating both basic and diluted earnings per share, and a reconciliation of these denominators to each other. That paragraph also requires disclosure of instruments that could potentially dilute basic earnings per share in the future but were not included in the calculation of diluted earnings per share because they are antidilutive in the period presented.

33. In the staff's view, the requirements in IAS 33 provide users the necessary information on the potential dilutive effect of an associate's share-based payments or share warrants. The information will be available to users, irrespective of whether the IASB decides not to develop requirements for these transactions.

Outreach

34. The staff reached out to accounting firms to understand:

    (a) whether it is common that an associate issues share-based payments or share warrants and, if so, if these transactions have a material effect on an investor's performance and financial position; and

    (b) what is the existing accounting practice of investors for an associate's share-based payment, and whether there appears to be divergence in practice.

35. Feedback in response to the question in paragraph 34(a) of this paper was that associates issue share-based payments in practice and more frequently if they are listed. Typically, these transactions do not involve amounts that are material for the investor.

36. In response to the question in paragraph 34(b) of this paper it was explained that:

    (a) during the vesting period, most investors include their share of an associate's share-based payment expense in their share of the investee's profit or loss, as required in paragraph 10 of IAS 28, and adjust the carrying amount of the investment for the same amount. One respondent noted that this adjustment results in the carrying amount of the investment no longer corresponding to the proportionate share of the investee's net assets. However, there are instances where an investor does not adjust the carrying amount of the investment and recognises instead a corresponding increase in its equity. It was noted that this is a method accepted under US GAAP;

    (b) there was consensus that when the shares are issued, the investor should consider the dilution as a partial disposal and recognise the change in its share of the associate's net assets; and

    (c) one respondent noted that there are no requirements for when a share-based payment lapses unexercised, which could result in diversity in practice.

Staff conclusion and recommendation

37. The IASB tentative decisions, set out in paragraph 14 of this paper, provide a solution for transactions and other events that change the investor's ownership interest. Whilst the tentative decisions address many of these transactions and events, they do not resolve how to apply the equity method when an associate issues a share-based payment and a share warrant discussed in this paper.

38. There is a wide range of potentially dilutive instruments and transactions. The staff think that trying to provide requirements for all possible fact patterns is not the objective of the project.

39. The outreach in paragraph 34 of this paper did not indicate that an associate's issuing share-based payments has a pervasive and material effect on an investor. Also, in the staff's view, the most important information during the vesting period is the information on the potential dilutive effect which IAS 33 requires to provide.

40. Considering the analysis and outreach in paragraphs 17–39 in this paper, the staff recommend the IASB does not develop proposals on how an investor applies the equity method when an associate issues an equity-settled share-based payment or a share warrant.

Question for the IASB
1. Does the IASB agree with the staff recommendation in paragraph 3 of this paper, that the IASB does not develop proposals on how an investor applies the equity method when an associate issues an equity-settled share-based payment or a share warrant?

Appendix

A1. The table summarises the effects of the transactions discussed in the paper.

Type of transaction	Does the investor's share of the associate's net assets change?		Is the associate's profit or loss affected?	Does the investor receive or pay cash?	Requirements
	Change in investor's ownership interest	Change in associate's net assets			
Investee's profit or loss	No	Yes	Yes	No	IAS 28.10
Distributions	No	Yes	No	Yes	
Purchases and partial disposals to a third party	Yes	No	No	Yes	IASB's tentative decisions
Associate's share capital transactions[6]	Yes	Yes	No	It depends.	
Associate's equity-settled share-based payment	See paragraph 20 of this paper	No	Yes	No	Transactions analysed in this paper
Share warrant	See paragraph 26 of this paper	Yes	No	No	

[6] When some existing shareholders do not participate in proportion to their existing ownership interest.