EFRAG

European Financial Reporting Advisory Group

12 April 2013

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Exposure Draft ED/2012/3 Equity Method: Share of Other Net Asset Changes

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft (ED/2012/3) *Equity Method: Share of Other Net Asset Changes* ('the proposed amendments' or 'the ED') issued by the IASB on 22 November 2012.

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG agrees that diversity in practice exists on how investors recognise their share of the changes in the net assets of an investee that are not recognised in profit or loss or other comprehensive income of the investee, and are not distributions received ('other net asset changes'). Therefore, EFRAG supports the IASB's efforts to address the issue.

However, we believe that a short-term solution should not create inconsistencies with existing IFRS nor introduce a new category of 'recyclable equity'.

Our due process has identified that constituents have significant concerns about the proposed amendments, and have diverse views on the accounting for other net asset changes. In our view, this indicates that the approach proposed by the ED is not appropriate. We therefore do not support the proposed amendments.

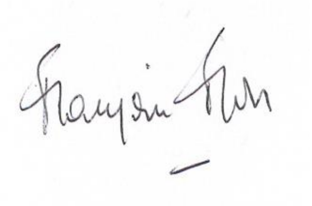
As explained in more detail in our responses to the questions raised in the ED and included in the Appendix, we believe the IASB should clarify the principles underlying the application of the equity method (for example, whether it is considered a 'one-line consolidation' or a valuation approach), in order to address the various types of transactions that result in other net asset changes, in a way that would provide a basis for resolving practice issues relating to the equity method and ensure consistency with existing IFRS. This would require the IASB to undertake further work on how to address the issue, which could be done before the IASB starts work on its longer term project on the equity method.

Although we do not propose an alternative solution to the issue, we have provided examples of types of transactions that could give rise to other net asset changes at the investee level.

We disagree with the proposed requirement to 'recycle equity'. In our view, there is no conceptual basis for a reclassification, especially given that the ED starts from the premise that other net asset changes should be treated in the same way as transactions with owners. The IASB is currently considering the principles that should govern ‘recycling’, and therefore we believe that this is not the time to introduce a new category of ’recyclable equity’. Our detailed comments and responses to the questions in the ED are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Benjamin Reilly, Isabel Batista or me.

Yours faithfully,



Françoise Flores

EFRAG Chairman

APPENDIX

EFRAG's responses to the questions asked in the Exposure Draft

Question 1

The IASB proposes to amend IAS 28 so that an investor should recognise in the investor's equity its share of the changes in the net assets of the investee that are not recognised in profit or loss or OCI of the investee, and that are not distributions received. Do you agree? Why or why not?

EFRAG's response

EFRAG disagrees with the proposed amendments. In our view, a short-term solution should not create inconsistencies with existing IFRS.

The current issues stem from a lack of clarity on the principles underlying the equity method and these should be clarified.

1 EFRAG believes that a short-term solution should not create inconsistencies with existing IFRS. The current issues stem from a lack of clarity on the principles underlying the equity method. These principles should be clarified in order to address the various types of transactions that could result in other net asset changes, in a way that would provide a basis for resolving practice issues relating to the equity method and ensure consistency with existing IFRS.

2 We therefore disagree with the proposed amendments, as explained in more detail below.

Inconsistency with IAS 1

3 The approach proposed by the IASB would present certain transactions between an investee and third parties as if they were transactions with the investor's owners. This proposed approach would lead to an inconsistency with the presentation requirements in IAS 1 *Presentation of Financial Statements*, which requires an entity to present all owner changes in equity within a statement of changes in equity. Non-owner changes are presented in the statement of comprehensive income, and arguably the investee's other net asset changes should also be presented in the statement of comprehensive income.

4 Furthermore, the accounting proposed would change the nature of equity as described in IAS 1; not only would the investee's equity transactions be recognised as if they were transactions in the investor's equity, but also the equity transactions of indirect associates and ventures held through an investee would be 'rolled-up' into the investor's equity.

5 Under IFRS, associates are not part of the 'group' which comprises only the parent and its subsidiaries. It therefore seems logical that the equity method should not follow the principles of the 'entity perspective' which only apply to a 'group'. We therefore disagree with the analogy made in paragraph BC6 of the ED.

6 Although the IASB acknowledges the inconsistency with IAS 1, as explained in paragraph BC8 of the ED, it concluded that going back to the past requirements would be the most reasonable and expeditious approach to address diversity in practice. However, EFRAG disagrees with this reasoning and notes that the amendments made in 2007 stated that:

> '11 Under the equity method … 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* other comprehensive income ~~equity that have not been recognised in the investee's profit or loss~~. 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 ~~directly in equity~~ in other comprehensive income of the investor (see IAS 1 *Presentation of Financial Statements* (as revised in 2007)).'

EFRAG believes that IAS 28 pre 2007 amendments did not require an investor to account for *all* types of other net asset changes in the investor's equity. In particular, the previous wording of IAS 28 already led to diversity in practice regarding the treatment of deemed disposals and acquisitions.

Purpose and application of the equity method of accounting

7 Central to the problems underlying the proposed amendments is a lack of clarity about the purpose of the equity method. As noted in paragraph BC6 of the ED, some believe that the equity method is a one-line consolidation, while others believe that it is more akin to a valuation approach.

8 IAS 28 describes the equity method as a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the net assets of the investee. This view, that the equity method is a valuation approach, is supported by paragraph BC24D of IAS 39 *Financial Instruments: Recognition and Measurement* which describes the equity method as an acquisition of a financial asset, and adds that the acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent net assets. Therefore it does not imply that the principles for business combinations and consolidations can be applied by analogy to the equity method.

9 We believe the IASB should clarify the principles underlying the equity method (for example, whether it is considered a 'one-line consolidation' or a valuation approach), in order to address this issue and other practice issues regarding the inconsistent application of the equity method. This would require the IASB to undertake further work on how to address the issue, which could be done before the IASB starts work on its longer term project on the equity method.

10 However, we note that neither a one-line consolidation approach nor a valuation approach logically leads to recognising other net asset changes in equity. As IAS 28 states that an associate or a joint venture is not part of the group, a one-line consolidation would follow the 'parent company' model and not the 'entity perspective' underlying IFRS 10 *Consolidated Financial Statements*. Under such a consolidation model, transactions (either direct or indirect) that increase ownership interest would not generate gains or losses (except when an acquisition of an associate or joint venture generates 'negative goodwill' in which case paragraph 32 of IAS 28 requires an excess in an investor's share in the fair value of identifiable net assets over its cost, to be recognised as a profit). However, transactions that decrease ownership interest could result in gains or losses.

11 In the paragraphs below, we have included examples of transactions that could give rise to other net asset changes at the investee level, and have included suggestions on how they might be accounted for under the equity method. The IASB could consider these when undertaking further work on the issue rather than finalise the amendments in their current form.

<u>Accounting for decreases in the investor's ownership interest in the investee (deemed disposals)</u>

12 Under the equity method, the investor recognises gains or losses arising from an actual disposal of an investee in its profit or loss.

13 We note that a decrease in the investor's ownership interest (i.e. decrease in percentage interest) in the investee might occur in different ways, for example, the investor's decision not to participate in an investee's share issue would result in an indirect decrease in its ownership interest. However, from an economic perspective, it could be argued that a decrease in an investor's ownership interest in an investee is economically equivalent to a (actual) disposal of a portion of the investee, and should therefore be accounted for in the same way. In both cases, the investor's ownership interest in the investee decreases. This is illustrated in the paragraph 10(d) of the ED.

14 Recognising dilution gains or losses in profit or loss resulting from a deemed disposal would be consistent with the existing requirement in IAS 28 to reclassify into profit or loss part of the amounts recognised in Other Comprehensive Income (OCI) on a partial disposal, and would provide useful information on a timely basis.

15 Deemed disposals and actual disposals are economically equivalent (although tax and legal requirements have an impact). The proposed requirements might encourage entities to engage in structuring of transactions to obtain the desired accounting outcome.

<u>Accounting for increases in the investor's ownership interest in the investee (deemed acquisitions)</u>

16 Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost. Although IAS 28 does not specifically address the accounting for any subsequent acquisition of additional investments in the same associate, the standard requires the investments accounted for under the equity method to be accounted for at cost. Therefore, if an investor increases its interest in an associate directly by acquiring additional shares, then the cost thereof would be accounted for as an increase in the investment.

17 An increase in the investor's ownership interest in the investee (a deemed acquisition) might occur, for example, when the investee buys back share capital currently in issue from third parties by paying cash. In this example, the investor is indirectly acquiring ownership interest from other shareholders although using the investee's cash to do so. In this case, the investor's ownership interest in the investee increases.

18 Similar to the rationale articulated above in relation to 'deemed disposals' of interest in an investee, one could argue that indirect increases in the investor's ownership interest are economically similar to the purchase of an additional stake in the investee, and should be accounted for in the same way.

<u>Other transactions that may potentially increase or decrease the investor's ownership interest in the investee</u>

19 An investee may enter into certain types of exchange transactions (e.g. share-based payments or writing call options) that have the potential to increase or decrease the investor's ownership interest (i.e. percentage interest) in the future, but that result in the receipt of consideration by the investee (e.g. services or cash) while not immediately affecting the investor's ownership interest (i.e. percentage held in the investee).

20 This raises the question whether the investor – in accounting for the effects of such an exchange transaction by the investee – should account for a share in the consideration received and whether or not it should ignore the potential future change in it percentage interest.

21 EFRAG believes that in developing an appropriate accounting solution for share-based payment transactions and transactions involving written options, the following factors could be considered by the IASB:

(a) Before an investor's ownership interest (i.e. percentage interest) effectively changes, an investor should only account for the other net asset changes in the investee that it owns and not for other elements that represent rights of other classes of equity instruments (e.g. preference shareholders or option holders).

(b) The overall effects of the transaction (i.e. the various legs of the transaction including any consideration received and the effects of exercise/lapse) should be reported in the same accounting period.

(c) If the transaction results in a deemed disposal or a deemed acquisition from the investor's perspective, those should be accounted for in the same way as actual disposals and acquisitions as explained in the paragraphs above.

22 For example, an investee writes a call option over its own shares and receives consideration of CU 10. If that transaction takes place at arm's length then, one could argue that an investor who holds a 30% interest in the investee should not recognise a Day 1 gain in profit or loss, OCI or equity as this ignores the dilutive potential of the transaction. Instead, the investor should recognise the overall effect of the exchange transaction once the uncertainty is resolved (i.e. when the option is exercised or lapses).

23 Under the proposals, the amounts in the investor's profit or loss and its statement of equity would be offset once the investee is disposed of, which might suggest that the investor's profit or loss and its statement of equity for each reporting period would not portray the performance of that period.

Transactions that do not result in a change in the investor's ownership interest

24 In addition, there may be changes in the net assets of an associate that will not result in a change in an investor's percentage ownership. For example, if an investee is an entity that is a group and buys out its own Non-Controlling Interest, the difference between fair value of the consideration transferred and carrying value of the Non-Controlling Interest will change an investor's share of net assets, but not its percentage ownership.

Question 2

The IASB also proposes that an investor shall reclassify to profit or loss the cumulative amount of equity that the investor had previously recognised when the investor discontinues the use of the equity method. Do you agree? Why or why not?

EFRAG's response

EFRAG disagrees with the proposed recycling requirements as they add complexity and an investor would fail to recognise in profit or loss on a timely basis any impairments of the investee. As the IASB's project on the Conceptual Framework is considering the broader issue of 'recycling', we believe that this is not the time to introduce a new category of 'recyclable equity'.

25 EFRAG disagrees with the proposed recycling requirements. They would add complexity and the investor would fail to recognise in profit or loss on a timely basis any impairments of the investee.

26 In our view, there is no conceptual basis for a reclassification, especially given that the ED starts from the premise that other net asset changes should be treated in the same way as transactions with owners. The IASB is currently considering the principles that should govern 'recycling', and therefore we believe that this is not the time to introduce a new category of 'recyclable equity'.

27 Furthermore, treating items recognised directly in equity on the same basis as items recognised in OCI might result in added complexity and cause confusion about the distinction between OCI and Equity.

28 Under the proposed accounting, the carrying amount of the investment might be reduced with a corresponding debit to the investor's equity if changes in the investee's equity result in an overall loss for the investor (dilution losses). Under such a circumstance, an investor would not recognise an impairment loss as the carrying value of the asset would have been reduced. As a consequence, losses might be deferred in equity and would only be presented in profit or loss when the investor discontinues the use of the equity method.

Question 3

Do you have any other comments on the IASB's proposals?

EFRAG's response

29 EFRAG does not have any other comments on the proposals.