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The Chairman
Australian Accounting Standards Board
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28 March 2013

Dear Mr Stevenson

Ernst & Young's global submission to the IASB on the Exposure Draft ED/2012/3 Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)

Please find enclosed Ernst & Young's global submission to the IASB on the above Exposure Draft.

Yours sincerely

Ernst & Young

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International Accounting Standards Board
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22 March 2013

Dear Board members

Invitation to comment – Exposure Draft ED/2012/3 *Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)*

The global organisation of Ernst & Young is pleased to respond to Exposure Draft ED/2012/3 *Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)* (the ED).

Whilst we support the efforts of the International Accounting Standards Board (IASB) to address the diversity in practice in accounting for 'other net asset changes' in an associate, we disagree with the proposed approach of recognising all types of other changes in an investee's net assets in investor's equity.

Principles of equity accounting

We believe that diversity in practice has arisen in accounting for other net asset changes due to competing conceptual theories when applying equity accounting. As we have discussed in previous comment letters to the IFRS Interpretations Committee (the Committee) and to the IASB, there are two differing views regarding the principle of equity accounting. Some view it as a type of one-line consolidation methodology, whilst others consider it to be a valuation methodology.   We believe that it is important for the IASB to establish a clear principle underlying the application of the equity method. In doing so, it will provide a basis for resolving practice issues regarding the equity method and ensure consistency in the application of equity method concepts.

However, under either of the views mentioned above, we do not believe there is a conceptual basis for the proposed recognition of other net asset changes in the investor's equity:

- If the fundamental principal for equity accounting is a one-line consolidation, the other ownership interests are not recognised in equity. Therefore, changes should not be recorded in equity.
- If equity accounting is primarily a valuation methodology for an investment then changes in the net assets of the investee that:
  - arise from changes in ownership, are more akin to purchases and sales of part of an investment and any changes in the relative ownership should be accounted for as such; and
  - arise from other events, are in the nature of income or expense and should be recognised in profit and loss or other comprehensive income.

We note that, whilst paragraph 26 of IAS 28 (2011) appears to support the view that equity accounting is a one-line consolidation, the IASB and the Committee have made a number of decisions recently that indicate that equity accounting is a valuation methodology for an investment, namely:

- The May 2008 Annual Amendment to IAS 28 by the IASB, which is explained by paragraph BC 27 of IAS 28 as follows: "*The Board decided that an investor should not allocate an impairment loss to any asset that forms part of the carrying amount of* ***the investment in the associate because the investment is the only asset that the investor controls and recognises***" (emphasis added);
- The April 2009 Annual Amendment to IAS 39 by the IASB, which is explained by paragraph BC 24D of IAS 39 as follows: "***the acquisition of an interest in an associate represents the acquisition of a financial instrument.***" (emphasis added). Paragraph BC 24D also contradicts paragraph 26 of IAS 28 by stating 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*"
- The July 2009 Agenda Decisions of the Committee with respect to potential effects of IFRS 3 on IAS 28 where the Committee noted that "*paragraph 19A of IAS 28 applies to all reductions in the investor's ownership interest, no matter the cause*".

In light of these consecutive changes, the proposed amendment to IAS 28 seems inconsistent and appears to return to pre-2007 requirements in IAS 28 (in paragraph 8 of the Basis for Conclusions).

We also observe that the justification put forward in paragraph 4 of the Basis for Conclusions that "*including the investor's share of the investee's equity transactions in profit or loss [does] not reflect performance*" seems at odds with the concepts underlying many of the IASB's current projects (e.g. revenue), which focus on reflecting changes in the reporting entity's rights and obligations in profit or loss rather than on its "performance".

We understand that the IASB intends to address the concept of equity accounting as part of a longer term project and cannot address these issues relating to the fundamental principle of equity accounting without undertaking an extensive project. However, we note that until these issues are addressed, inconsistent approaches will continue to arise as constituents take alternative views regarding various aspects of equity accounting.

Suggested approach

Despite the need for clarity on the principles of equity accounting, we believe that the IASB should address the diversity in accounting for other net asset changes in the short term. In our view the guiding principle when accounting for equity method re-measurements ought to be that consolidation principles are applied except in the circumstance in which there is a clear conflict between those principles and investment asset accounting, in which case, asset accounting principles would be applied.

In Appendix B to this letter, we have included details of certain aspects of this proposed approach for your consideration.

We believe that approaching the application of equity accounting in this manner would provide a rational and disciplined approach for dealing with equity method re-measurement issues. In addition this approach would not change current practice related to deemed purchases and disposals where there is little or no diversity in practice, however it would address the original issue that led to the ED.

Additional considerations – IAS 1

We believe that the proposed recognition of other changes in net assets in investor's equity, creates an exception to the requirement in paragraph 88 of IAS 1 *Presentation of Financial Statements* to recognise all items of income and expense in a period in profit or loss. Whilst the proposal would eliminate diversity in practice related to one specific practice issue, we believe it will inevitably give rise to other potential issues in the future. In that respect, we agree with the dissenting opinion of Mr. Ochi that the proposed amendment would undermine other IFRS and would also be inconsistent with the concept of IAS 1.

In Appendix A we answer the specific questions posed by the ED and set out some examples of transactions that fall within 'other net asset changes', where we disagree with the recognition in investor's equity.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas on +31 88 407 5035 or Victoria O'Leary on +44 (0) 20 980 0515.

Yours faithfully

Ernst & Young

Appendix A – Responses to the questions in the Exposure Draft ED/2012/3 *Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)*

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?

We do not agree that all other changes in net assets should be recognised in the investor's equity. We believe that a reduction in an interest is a deemed disposal, which gives rise to a dilution gain or loss, and this gain or loss should be recognised in the investor's profit or loss. Although IAS 28 does not explicitly state that an investor should recognise a gain or loss on partial disposal of an interest in an associate, under equity accounting it is clear that an investor only accounts for its own interest in the associate. Given that the investor's other ownership interests are not reflected in the accounts of the investor, there is no basis for treating partial disposals as equity transactions. Therefore, treating deemed disposals as equity transactions may give rise to opportunities for entities to structure transactions in order to achieve a particular accounting outcome.

Deemed disposals of foreign operations
In addition to the concerns above, if the associate is a foreign operation, accumulated exchange gains and losses may have been recognised in other comprehensive income. Under this proposal, upon a deemed disposal, the gain or loss on the disposal itself is recognised in the investor's equity. However, other accumulated foreign exchange gains or losses will have been reflected in OCI and on disposal should be recycled to profit or loss, as required by IAS 21 *The Effects of Changes in Foreign Exchange Rates*. The proposed amendment does not address this apparent inconsistency.

Equity-settled share-based payment transactions
When an associate issues equity-settled share options, the associate recognises an expense within profit or loss of which the investor recognises its proportionate share, with a corresponding reduction in the carrying amount of the investment in the associate. We believe that the investor should not recognise an adjustment to the investor's equity because it is not part of the comprehensive income of the associate and does not represent a dilution of the investor's interest, until such time as shares are issued. Therefore, we believe that the investor should account for the dilution gain or loss in net income on reduction in its proportionate interest as a deemed disposal at the date *at which the options* are exercised. This approach is also consistent with the requirement in IAS 28 for dealing with undeclared dividends on cumulative preference shares held by parties other than the investor.

Appendix A – Responses to the questions in the Exposure Draft ED/2012/3 *Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)*

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 use of the equity method. Do you agree? Why or why not?

We do not agree with the proposal to reclassify the cumulative equity adjustments to profit or loss as this contradicts the concept in IAS 1 that only reclassifications between other comprehensive income and profit or loss are permitted.

Question 3—Transition

Do you have any other comments on the proposals?

The ED proposes full retrospective application. Whilst we understand this conceptually, we have concerns that it may be too onerous and the benefit of full retrospective application may be outweighed by the cost of doing so.

Appendix B – Suggested Approach

As discussed in the cover letter, we believe the guiding principle when accounting for equity method re-measurements ought to be that consolidation principles are applied except where there is a clear conflict between those principles and investment asset accounting, in which case asset accounting principles would be applied. The following points elaborate on this view:

(1) The 'trigger' for a re-measurement of the investor's share of net assets ought to be the same as the consolidation triggers for the re-measurement of the parent and non-controlling interests (NCI).

For a subsidiary this would occur when there is a change in present ownership interests. It does not occur when the subsidiary enters a share-based payment (SBP) arrangement or issues an option or convertible note. Instead, the amount would be recorded in NCI and would remain there until the SBP or option lapses or until it is exercised to become a present ownership interest.

For an equity method investment, only the investor's interest is recognised. The equity relating to a SBP or option issued by the investee is equivalent to a subsidiary's NCI. Therefore, these transactions should not result in a re-measurement of the investor's share of net assets until the SBP or option lapses or is exercised, at which point it becomes a present ownership interest.

(2) A change in ownership interest is a trigger for re-measurement. However, we believe consolidation principles cannot be applied to this change in ownership interest. Rather, for an equity method investment, since the investor does not have a controlling financial interest, these transactions are deemed purchases and sales.

For a subsidiary, a change in ownership that does not result in a change in control is accounted for as an equity transaction. This is appropriate as both the parent and the non-controlling equity interests are recognised in the consolidated accounts.

For an equity method investment, since the ownership interests not owned by the investor are not recognised, changes in ownership interests should not be accounted for as an equity transaction. Rather such transactions are, in substance, purchases and sales of part of the investment and they should be accounted for as such.

(3) Consolidation principles are not appropriate for transactions between an associate and the associate's NCI.

For a subsidiary such transactions would be accounted for as an equity transaction.

For an equity method investment, since the non-investor equity interests are not recognised, any changes in the measurement of the investment cannot be equity transactions and are rather in the nature of income or expense.