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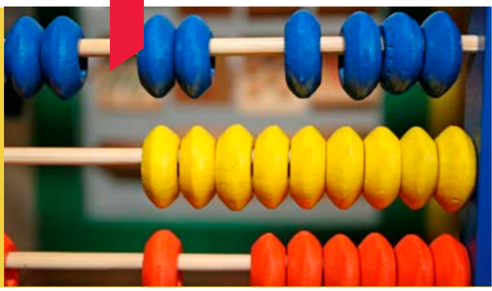
HKFRS / IFRS UPDATE 2012/11

EQUITY METHOD: SHARE OF OTHER NET ASSET CHANGES



STATUS
Exposure Draft

EFFECTIVE DATE
To be confirmed

ACCOUNTING IMPACT
May be significant

HKICPA invites comments on the IASB's Exposure Draft of *Equity Method: Share of Other Net Asset Changes*. The invitation and the Exposure Draft have been posted on HKICPA website at: http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/

This Update provides the background and highlights the proposals of the Exposure Draft. When the proposals are finalised as amendments to IAS 28, it is expected that equivalent amendments would be made to HKAS 28 under the HKICPA's policy to converge HKFRS with IFRS.

The comment period in Hong Kong will end on 22 February 2013 whereas the IASB sets its closing date on 23 March 2013.

Summary

On 22 November 2012 the International Accounting Standards Board (IASB) published Exposure Draft *ED/2012/3 Equity Method: Share of Other Net Asset Changes* which proposes amendments to IAS 28 *Investment in Associates and Joint Ventures (2011)* to address changes in the investor's share of the net assets of an investee that are not recognised in profit or loss or other comprehensive income and are not distributions received from the investee ('other net asset changes').

The proposed amendments to IAS 28 specify that an investor should recognise its share of the investee's other net asset changes in equity.

The proposed effective date for the amendments is yet to be confirmed, however the amendments would be required to be applied retrospectively.

Background

The equity method is the prescribed method of accounting for interests in associates and joint ventures (as defined by IFRS 11 *Joint Arrangements*). Paragraph 3 of IAS 28 defines the equity method of accounting as one whereby the investment is initially recognised at cost and subsequently adjusted for the post-acquisition change in the investor's share of the investee's net assets.

The objective of the exposure draft is to provide additional guidance on the application of the equity method, in instances where changes in the net assets of an investee are not recognised in profit or loss or other comprehensive income of the investee, and are not distributions received from the investee.

Guidance did previously exist in earlier versions of IAS 28, however this guidance was removed by a consequential amendment in 2007 as part of the revision to IAS 1 *Presentation of Financial Statements*. This resulted in paragraph 10 of IAS 28 no longer stating whether, and if so, where, the investor should account for other net asset changes of the investee. Accordingly, some constituents considered that paragraphs 3 (definitions) and 10 (equity method) were inconsistent with each other, or at least unclear.

Subsequent to the consequential amendment, the issue was brought to the attention of the IFRS Interpretations Committee, who in turn recommended that the IASB make a limited scope amendment to the new IAS 28 *Investments in Associates and Joint Ventures (2011)* – as the currently effective IAS 28 *Investments in Associates* would be superseded for periods beginning on or after 1 January 2013.

Proposed amendments

As mentioned above, the proposed amendments provide additional guidance within IAS 28 on the application of the equity method, in instances where changes in the net assets of an investee are not recognised in profit or loss or other comprehensive income of the investee, and are not distributions received from the investee.

Paragraph 10 of IAS 28 has been significantly restructured to provide a step-by-step guide, with examples, of how an entity is to apply the equity method.

Proposed amendments to the description of the equity method

Under the proposed amendments to paragraph 10 of IAS 28, an investor applies the equity method by initially measuring its investment in an associate or a joint venture at cost.

Subsequently, the carrying amount is increased or decreased to recognise changes in the investor's share of the investee's net assets, in the following manner:

a) The investor's share of the investee's profit or loss is recognised in the investor's profit or loss

b) The investor's share of the investee's components of other comprehensive income is recognised in the investor's other comprehensive income. Such changes include:
   - Remeasurement of the net defined benefit liability (asset)
   - Revaluation of property, plant and equipment
   - Foreign exchange translation differences.

c) Distributions received from an investee reduce the carrying amount of the investment. These include:
   - Dividends in cash or other assets
   - Returns of invested capital.

d) The investor's share of any other changes of the investee's net asset, other than profit or loss or other comprehensive income and distributions received, is recognised in the investor's equity. For example:
   - Movements in the share capital of the investee (e.g. when an investee issues additional shares to third parties or buys back shares from third parties)
   - Movements in other components of the investee's equity (e.g. when an investee accounts for an equity-settled share-based payment transaction).

Proposed example added

To illustrate point d) above, the proposed amendment includes an example. This is replicated below:

Background facts and circumstances:

- Investor A has 30% investment in its associate, Investee X
- Investee X issues additional shares to a third party for cash of CU500
- As a result, Investor A's relative share-holding decreases from 30% to 25%
- As a result, Investee X's net assets increase from CU1,000 to CU 1,500 (on account of receiving additional cash for the shares issued to the third party).

Effect:

- Investor A's share in pre-existing net assets is diluted by CU50
  [(CU1,000 x 30%) – (CU1,000 x 25%)]
- Investor A's share of the investee's new net assets increases by CU125
  [(CU500 x 25%)]
- The net effect is an increase in Investor A's share of the investee's net assets of CU75
  [(CU1,500 x 25%) – (CU1,000 x 30%)].

Resulting adjustment:

- Investor A records a CU75 increase to its investment and a CU75 increase to its shareholder's equity.

Proposed amendments to discontinuing the use of the equity method

The proposed amendments also state that on discontinuing the use of the equity method, because the investment has ceased to be an associate or joint venture, the investor should reclassify to profit or loss the cumulative amount of other net asset changes that had been previously recognised in the investor's equity in accordance with paragraph 10(d).

The amendment notes that that an investor might discontinue the use of the equity where the investment in the investee becomes a subsidiary (investor gains control) or a financial asset (investor loses significant influence). In both cases the investor would reclassify to profit or loss the cumulative amount of other net asset changes that had been previously recognised in the investor's equity.

Proposed amendments to other changes in ownership interest

If the investor's ownership interest in the investee is reduced but the investor continues to apply the equity method there is no reclassification of the cumulative amount of other net asset changes that had been previously recognised in the investor's equity. That reclassification only occurs when the investor discontinues the use of the equity method.

Proposed amendments to terminology

The proposed amendment also changes the terminology within IAS 28, changing 'entity' to 'investor' to be consistent with the terminology of IFRS 11 *Joint Arrangements*.

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