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

Dear Sir/Madam,

Comments on the Exposure Draft "Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)"

We welcome the opportunity to provide comments on the Exposure Draft "Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)" (hereinafter referred to as "the ED").

1. We disagree with the proposal in the ED because of inconsistency with fundamental principles of IFRSs, as well as issues to be considered in conjunction with the Conceptual Framework for Financial Reporting.

2. We also recommend that issues related to the equity method should be addressed from long-term perspectives, given that it is one of the research projects as a result of the IASB's Agenda Consultation.

<u>Question 1</u>

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?

3. We disagree with the proposal for the reasons explained below.

Inconsistencies in the IASB's proposal

4. We observe that the IASB's proposal, which would recognise in investor's equity its

share of the changes in the net assets of the investee, is inconsistent with the following fundamental principles in IFRSs:

- The fundamental principle in IFRS 3 and IFRS 10 (IAS 27) that a group is composed of a parent and its subsidiaries and that changes in a parent's ownership interest that do not result in the loss of control are equity transactions, in accordance with the concept of a significant economic event; and
- The fundamental principle in IAS 1 that transactions with owners and transactions with non-owners should be clearly distinguished.

5. First, from the viewpoint of the above-mentioned principle in IFRS 3 and IFRS 10, such transactions with an associate cannot be equity transactions because an associate is not a part of the consolidated group and the investor has not yet obtained control of the associate. This means that other net asset changes of an associate are transactions with non-owners, rather than transactions with owners of the group. Second, from the viewpoint of the above-mentioned principle in IAS 1, transactions with non-owners would be presented in the statement of comprehensive income as transactions generating income or expenses.

6. In addition, under the IASB's proposal in the ED, conceptual anomalies would arise in the cases where a subsidiary issues additional shares to third parties in stages[1]. For example, if the first transaction is a change in ownership interest that does not result in loss of control, the second transaction is a change that results in loss of control but retains significant influence, and the third transaction is a change that does not result in loss of significant influence, then the first would be recognised in equity, the second in profit or loss, and the third would again lead to an equity transaction.

7. We disagree with the IASB's proposal because it is inconsistent with the above-mentioned fundamental principles and thus might cause serious interpretation issues. From this viewpoint, we also disagree with the IASB's rationale in paragraph BC5 of Basis for Conclusions in the ED.

Alternative view by the ASBJ

[1] Needless to say, we note that, for the transaction for short-term structuring purposes that may occur in practice, the analogy to the circumstance where a parent should account for the transactions as a single transaction (paragraph B97 of IFRS 10).

8. We believe it is important to address this issue on the basis of the fundamental principles in IFRSs. In other words, application and interpretation of the fundamental principles in IFRS would enable us to find the most appropriate treatment under the existing IFRSs. This would also resolve inconsistency.

9. From this perspective, we suggest that other net asset changes of the investee should be recognised in the investor's profit or loss.

10. At the same time, we note that there is diversity in current practice because of the lack of clarity in IAS 28. Although we do not believe it is appropriate to treat such transactions as equity transactions, as mentioned in paragraph 5 above, we acknowledge diversity in practice. Clarification of this issue should be sought in the IASB's future research project on equity method of accounting.

11. The reasons why we suggest that recognition in profit or loss would be appropriate as an interpretation of the existing IFRSs are as follows:

    (1) First, in accordance with the definition of the equity method[2] (paragraph 3 of IAS 28), all changes in an investor's share in net asset of an investee should be recognised.

    (2) Second, because paragraph 11 of IAS 28 does not specify how an investor should account for its share of other net asset changes of the investee, we believe that fundamental principles or requirements of other IFRSs which address similar or related matters (i.e. IFRS 3, IFRS 10 and IAS 1) should be referred to, by applying the fundamental principles on selection of accounting policies in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (paragraphs 10 and 11).

    (3) Third, we should determine whether to recognise such transactions in equity or income/expenses on the basis of the fundamental principles in IFRS 3, IFRS 10 (IAS 27) and IAS 1, as mentioned above. According to those principles, such transactions are not transactions with the owner of the group and therefore should not be recognised in equity but should be treated as transactions with non-owners that generate income or expenses.

    (4) Fourth, we should determine whether the resulting income or expenses should

[2] "*The equity method* is 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 investee's net assets."

be recognised in profit or loss or in other comprehensive income. The IASB is going to clarify the concept of "other comprehensive income" in the Conceptual Framework project. Given the lack of clear definition and application principle, we believe it would be inappropriate to expand the use of other comprehensive income at this moment and therefore we suggest that recognition in profit or loss is appropriate as a residual of income or expenses.

12. We believe our suggestion would have the following advantages:

- It would achieve the most appropriate accounting treatment on the interpretation of IFRSs without departing from the IFRS structure.
- It would retain consistency with the Conceptual Framework and fundamental principles in other IFRSs.
- It would avoid complexity in reclassifying to profit or loss as proposed by the IASB.
- It would eliminate diversity and enable the uniform treatment in the future.

The concept of "one-line consolidation"

13. We note the concept of "one-line consolidation", but we do not believe that all of the principles applied in consolidation should be also applied to the accounting for associates. We observe that the current requirements for the equity method contain some departures from the concept of one-line consolidation.

14. For example, paragraph BC24D of IAS39 states, "The Board noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures."

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?

15. From the viewpoint of our response to Question 1 that the share of other net asset changes should be recognised in profit or loss, we would not be in a position to comment on Question 2. However, we are concerned about the IASB's proposal to require reclassifying 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.

Concerns relating to the IASB's proposal

16. We observe that reclassification of such an amount to profit or loss would cause the following inconsistencies:

- Inconsistency with the notion of a one-line consolidation on which the IASB's proposal is based

  Paragraph B98 of IFRS 10 does not require reclassification of the cumulative amount previously recognised in equity to profit or loss when control is lost as the changes in interests that do not result in loss of control,. If the notion of a one-line consolidation is to be followed, it would be inconsistent to reclassify that amount to profit or loss as the IASB proposed in the ED.

- Inconsistency with the fundamental principle in IAS 1

  In the light of the fundamental principle in IAS 1 that transactions with owners and transactions with non-owners should be clearly distinguished, it would be inconsistent to reclassify an item arising from an equity transaction previously presented in the statement of changes in equity to profit or loss in the statement of profit or loss and other comprehensive income when discontinuing the use of the equity method.

- Inconsistency with other IFRSs prohibiting reclassifying equity to profit or loss

  (a) Paragraph 33 of IAS 32 *Financial Instruments: Presentation* states, "No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments."

  (b) Paragraph AG32 of IAS 32 states, "On conversion of a convertible instrument at maturity, the entity derecognises the liability component and recognises it as equity. The original equity component remains as equity. There is no gain or loss on conversion at maturity."

  (c) Paragraph 23 of IFRS 2 *Share-based Payment* states, "the entity shall not subsequently reverse the amount recognised for services received from an employee if the vested equity instruments are later forfeited or, in the case of share options, the options are not exercised."

- It would produce two types of components of equity (items which will be reclassified to profit or loss and those which will not), like other comprehensive income, which would be difficult to explain conceptually.

<u>Question 3</u>

Do you have any other comments on the proposals?

17. We consider it inappropriate that IASB's proposal is based on the idea of returning to the previous requirements as a short-term solution. In addition, we have a serious concern about the proposal to require retrospective application.

Concerns relating to returning to the previous requirements as a short-term solution

18. We consider it inappropriate for the IASB to base its conclusion on returning to the legacy requirements as a short-term solution, due to the following perspectives.

    - The proposed treatment is inconsistent with the fundamental principles clarified by the revisions to related standards (the revision to IAS 1 in 2007 and the revisions to IFRS 3 and IAS 27 in 2008)
    - Contrary to the IASB's principle-based approach to developing IFRSs, the IASB has developed an exception without sufficient deliberation and has acknowledged the inconsistency with the fundamental principles (as admitted in paragraph BC8 of the ED).
    - The previous requirement in IAS 28 prior to the revision to IAS 1 in 2007 appeared to cover only the items recognised directly in equity, which became items of other comprehensive income after the revision to IAS 1 in 2007. (This is inferred on the basis of paragraph 10 of IAS 28, which states, "such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences.")
    - Even prior to the amendment mentioned above, it does not seem that IAS 28 anticipated the accounting for other net asset changes as proposed in the ED. (This would be reasonably expected, given that IAS 27 prior to the 2008 revision did not specify the accoutring for the changes in ownership interests).
    - The IFRS Interpretations Committee, at its meeting in July 2009, had once made an agenda decision that share of a certain kind of other net asset change should be recognised in the investor's profit or loss, same as our suggested

alternative.

- Given that the treatment of other net asset changes in the ED is closely related with the issues in the Conceptual Framework and fundamental principles of other Standards, a short-term solution would not be preferable. In addition, the equity method is included as one of the IASB's research projects.

Concerns relating to retrospective application

19. We have a serious concern about the proposal to require retrospective application because it would not result in stable application of the standards as follows:

- In practice, some entities recognise its share of other net asset changes of the investee in the investor's profit or loss, as recommended in our comments.

- As mentioned above, the IFRS Interpretations Committee once made an agenda decision that share of a certain kind of other net asset change should be recognised in the investor's profit or loss, at its meeting in July 2009.

- IAS 27 amended in 2008 prohibited its retrospective application (paragraph 45 of IAS 27 (2008), now paragraph C3 and C6 of IFRS 10), in the situation where there were divergent practices prior to the amendment due to lack of requirements on how to account for changes in ownership interests in consolidation.

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We hope our comments will contribute to the forthcoming deliberations in the ED.

Yours sincerely,

Atsushi Kato
Vice Chairman of the Accounting Standards Board of Japan