IFRS

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Project: **Annual Improvements—2010–2012 cycle**

Topic: **Issues that the Committee recommends should not lead to amendments within the scope of the *Annual Improvements* process**

Introduction

1. At its meeting in May 2011 and July 2010 the IFRS Interpretations Committee (the Committee) reviewed a selection of issues for potential resolution through the Annual Improvements process for 2010-2012.

2. The Committee tentatively decided to recommend that the Board should not proceed with four of those issues through the Annual Improvements process.

3. This paper discusses the following four issues:

   (a) IFRS 2 *Share-based Payment*—modification of a share-based payment from cash-settled to equity-settled;

   (b) IAS 27 *Consolidated and Separate Financial Statements*—contributions to a jointly controlled entity or an associate;

   (c) IAS 28 *Investments in Associates* –purchase in stages – fair value as deemed cost

   (d) IAS 28 *Investments in Associates* – equity method.

Purpose of this paper

4. The objective of this paper is to:

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) present background information on these issues and give an overview of our analysis of them,

(b) explain the rationale for the Committee's decision to recommend that the Board should not amend the relevant standards through Annual Improvements, and

(c) ask for the Board's agreement with the Committee's recommendation.

IFRS 2 *Share-based Payment*—modification of a share-based payment from cash-settled to equity-settled

5. The following is a summary of the analysis presented to the Committee in May 2011. Our full analysis was set out in Agenda Paper 7, which can be found on the public website, and includes the text of the original submission.

Background information

6. In March 2011 the Committee received a request to clarify the accounting for a modification of a share-based payment that changes its classification from cash-settled to equity-settled. The submission provided a fact pattern of a cash-settled award that is cancelled and is replaced by a new equity-settled award with a higher fair value.

7. The request raised an issue about how to measure the replacement award in situations where:

   (a) a cash-settled award is cancelled and is replaced by a new equity-settled award; and

   (b) the replacement award has a higher fair value than the original award.

8. The submitter stated that, because IFRS 2 *Share-based Payment* is silent regarding this issue, diversity exists in practice, and suggested that this issue could potentially be considered as a clarification to IFRS 2, through the annual improvements project.

9. The submitter identified two different views on how to measure the replacement award, as follows:

View 1

10. This approach considers that the award has been modified (in the fact pattern, the award changes from being cash-settled to equity-settled). Consequently, under this approach the modification guidance in IFRS 2 (paragraphs 27 and B42–B44) would be applied by analogy.

11. Under the modification guidance in paragraphs 27 and B42–B44 of IFRS 2, the measurement of the equity-settled award is based on:

    (a) the grant-date fair value of the **original award**; with such cost being recognised over the original vesting period; and

    (b) the recognition of an incremental fair value (as the difference between the fair value of the **modified equity instrument** and that of the **original equity instrument,** both estimated as at the **date of the modification**).

View 2

12. This approach considers that the original award has been settled and replaced by a new award (ie the cash-settled award has been cancelled and settled by an equity-settled award).

13. Under this approach, there is a shared understanding at the original grant date that the payment would be settled in cash; but at the date of the modification, the shared understanding changes and the entity is obliged to issue equity instruments. The cash-settled award is cancelled and replaced by an equity settled award.

14. Because IFRS 2 lacks specific guidance applicable to situations where a cash-settled award is cancelled and replaced by an equity-settled award, the submitter refers to the guidance in IFRS 2 that is applicable when awards are settled. The relevant guidance for this analysis is as follows:

    (a) cancellations or settlement of equity-settled awards in cash (IFRS 2.28)

    (b) share-based payment transactions in which the terms of the arrangement provide the counterparty with a choice of settlement (IFRS 2.39); and

    (c) share-based payment transactions in which the terms of the arrangement provide the entity with a choice of settlement (IFRS 2.43)

(d) IFRS 2 also contains guidance on situations where a cash-settlement alternative is added to an equity-settled award after grant date (IG Example 9).

15. An argument is made that the requirements in IFRS 2 relating to cash-settled awards do not include guidance regarding modifications on the grounds that the liability is remeasured to its fair value and any modifications for the original award would therefore be automatically reflected in the carrying value of the liability. However, this "modification" is more significant, in so far as according to the fact pattern included in the submission, a cash-settled award is replaced by an equity-settled one. There is therefore no "automatic" reflection of the change. View 2 attempts to overcome this concern by viewing the change as settlement of the cash-settled award followed by replacement with an equity-settled award.

16. Under this view, at the date of the modification, the entity reclassifies to equity the carrying amount of the liability recognised to-date. The submission includes two further sub-approaches for recognising the difference between the modification date fair value of the replacement equity-settled share-based payment arrangement and the amount reclassified to equity over the remaining vesting period, as follows:

    (a) View 2A: it is recognised as an expense over the remaining vesting period in accordance with IFRS 2.B43(b); or

    (b) View 2B: it is recognised immediately in profit or loss as an additional expense in accordance with IFRS 2.43(c) to the extent of services provided.

Summary of the staff's analysis

Staff analysis view 1: apply by analogy the modification guidance in IFRS 2

17. In our view, the guidance for modification in IFRS 2 is framed upon the modification of the terms and conditions of equity-settled share-based payment awards (for example, a reduction or increase of the equity instruments awarded, or a modification of the exercise price of the award). That is, the guidance in IFRS 2 appears to have been written in the context of modifications that do not change the classification of the award. We do not think that it was intended to deal specifically with situations where, during the vesting period, an award is modified either from:

(a) being an equity-settled share-based payment to being a cash-settled share based-payment; or

(b) being a cash-settled share-based payment to being an equity-settled share-based payment (the latter being the subject of the submission received).

18. Nevertheless, even though IFRS 2 is silent regarding this type of transaction, we agree that the modification guidance in IFRS 2 could be applied by analogy when recognising awards that change from being cash-settled to being equity-settled, on the grounds that the terms and conditions of the award have 'changed', irrespective of whether equity-settled share based payments were originally granted.

19. When analysing the fact pattern in the submission under View 1 we observed that the application of the modification principles in IFRS 2.27 to the modified 'cash-settled award' results in the recognition of the fair value of the original award at modification date (CU60) plus the unrecognised grant-date fair value of the original award of CU50 plus an incremental fair value of CU12. Consequently the modified award reflects a value of CU122.

20. We observe that the award does not reflect the fair value of the share options granted (CU 132) measured at modification date. We note that View 1 takes this approach because paragraph 27 of IFRS 2 requires the cost of the original award to remain 'frozen' at its original grant-date fair value in order to recognise at a minimum the cost of the *original* award at its grant date fair value as if it had not been modified and also requires the recognition of an incremental value that reflects the effects of modifications that increase the total fair value of the original award.

21. In our view, this guidance might not be adequate for measuring awards that change from being cash-settled to being equity-settled, because we think it might contradict the measurement for a cash-settled award. This is because, in accordance with paragraph 30 in IFRS 2, the valuation of a cash-settled award does not follow a grant date fair-value approach in its valuation and instead follows a remeasurement fair-value approach.

Staff analysis view 2: do not apply the modification guidance in IFRS 2 and instead consider that the original award has been settled and replaced by a new award

22. We observe that under this approach, there is a shared understanding at the original grant date that the payment would be settled in cash; but at the date of the modification, the shared understanding changes and the entity is obliged to issue equity instruments. The cash-settled award is cancelled and replaced by an equity settled award.

23. We observed that in contrast to View 1 that reflects a value of the new award of CU 122 for the fact pattern in the submission, View 2 (including View 2A and View 2B) results in the new award reflecting the value of the share options granted (CU 132) measured at modification date. However, to arrive at this, the submitter had to apply different sources of guidance from IFRS 2, which do not necessarily replicate the assumptions of the fact pattern described in the submission. For instance, in the fact pattern presented, the entity originally granted a cash-settled award, then cancelled this grant and decided to issue an equity-settled award and:

    (a) the entity did not have a 'choice of settlement'; but the submitter applied the guidance in paragraph 39 to measure the original cash-settled share based-payment transaction at the date of settlement in View 2A and View 2B; and

    (b) the counterparty did not have a 'choice of settlement'; but, the submitter applied by analogy the guidance in paragraph 43(c) to measure the original cash-settled share based-payment transaction at the date of settlement in View 2B.

24. Consequently, although we agreed with the resulting valuation of the replacement equity award shown in View 2A and 2B because it reflects the value of the share options granted (CU 132) measured at modification date, this would imply analogising the transaction to different sources of guidance in IFRS 2 which adds confusion and subjectivity to this approach. In our opinion the measurement of cash-settled share based payment transactions replaced by equity-settled share-based payment transaction should be made clear in IFRS 2 to avoid this.

The staff's preferred view

25. We think that the fact pattern reflects, in substance, a modification of the terms of the agreement from being cash-settled to being equity-settled. Consequently, the guidance in paragraphs 27 and B42–B44 of IFRS 2, regarding the modification of equity awards could be extended to apply to the fact pattern included in the submission as proposed by View 1.

26. Our view is also based on the content of paragraph 28(c) of IFRS 2 which states that when new equity instruments are granted, these are identified as replacement equity instruments for the cancelled equity instruments and the entity shall account for them in the same way as a modification of the original grant. Based on this, we think that the transaction analysed in the submission is in substance a modification.

27. We considered making a clarification to the modification guidance in IFRS 2 (paragraphs 27 and B42–B44) to state that when a cancellation of an award is followed by a replacement or a new award, and the two transactions are made in contemplation of each other, then in substance this is a modification and the modification guidance in IFRS 2 should be applied.

28. However, we think that making this clarification is outside the remit of the annual improvement process, for the following reasons:
    (a) the current guidance in IFRS appears to be written in the context of modifications that do not change the classification of the award; and
    (b) adding a clarification to the modifications guidance may require reconsideration of the measurement principles in IFRS 2 that are applicable to modifications, cancellations or settlements of arrangements, either by:
        (i) creating new general principles that would be applicable to any type of modification of arrangements, or by
        (ii) creating specific principles for each possible type of modification

Interpretations Committee's recommendation to the Board

29. The Committee agreed with the staff view that the amendments that would be necessary to IFRS 2 to provide specific guidance on the modification of a share-based payment that changes its classification from cash-settled to equity-settled would be beyond the annual improvements project and would be better to be addressed as part of a separate IASB project to improve IFRS 2.

30. Consequently, the Committee recommend that the Board should not address this issue through annual improvements and instead, should consider this matter in a future agenda proposal for IFRS 2.

Question to the Board

Question 1—Interpretations Committee's recommendation
1. Does the Board agree with the Committee's recommendation not to propose an amendment through Annual Improvements for this issue? 2. Does the Board agree that the issue should be considered as part of an agenda proposal for improvements to IFRS 2?

IAS 27 *Consolidated and Separate Financial Statements*—contributions to a jointly controlled entity or an associate

31. The following is a summary of the analysis presented at the Committee in May 2011. Our full analysis was set out in Agenda paper 13, which can be found on the public website

Background information

32. The Committee received three requests asking for clarification of the accounting when a parent loses control over a subsidiary and that subsidiary is contributed so as to become (part of) a jointly controlled entity (JCE) or an associate. In particular, the Committee was asked whether a parent should recognise the full gain or loss resulting from the transaction or only to the extent of the interests of the other equity holders in the JCE or the associate.

33. More specifically some of these requests do not only address the scenario where the parent contributes interests in a subsidiary to the JCE and this contribution results in a loss of control in the subsidiary by the parent but also scenarios where a JCE is established other than by contributing interests in a subsidiary. The submitters had scenarios in mind where the parent sells shares to the other venturers or dilutes its interest in the subsidiary by the subsidiary issuing new shares to the other venturers.

34. One submitter asked:

(a) whether the same approach should be applied when the interest in the subsidiary is not replaced by an interest in a JCE but by an interest in an associate; or

(b) whether it makes a difference if the subsidiary is a business (as defined in IFRS 3 *Business Combinations*) rather than a single asset.

35. The Board discussed the scenario where the parent contributes interests in a subsidiary to a JCE and this contribution results in a loss of control in the subsidiary by the parent at its December 2009 meeting[1] and concluded that there is an inconsistency between the guidance in IAS 27 on the one hand and IAS 31 together with SIC-13 on the other when a subsidiary is contributed to a JCE. Paragraph 5 of SIC-13 restricts gains and losses arising from contributions of non-monetary assets to a JCE to the extent of the interest attributable to the other equity holders in the JCE, whereas paragraph 34 of IAS 27 requires full profit or loss recognition on the loss of control.

36. In addition, the following tentative decisions of the Board were reported in IASB Update December 2009:

    (a) not to resolve the inconsistency between IAS 27 *Consolidated and Separate Financial Statements* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* within the joint venture project, but to deal with it separately;

    (b) to incorporate the requirements in SIC-13 and any guidance relating to the equity method for joint ventures as a consequential amendment to IAS 28 *Investments in Associates.*

[1] http://www.ifrs.org/NR/rdonlyres/26D750E8-816B-4F8C-A919-5B78991A1913/0/JV1209B11Bobs.pdf

37. These tentative decisions of the Board have been transformed by IAS 28 *Investments in Associates and Joint Ventures* (revised 2011).

Summary of the staff's analysis

38. Acknowledging the conclusion reached and the tentative decisions taken by the Board in the December 2009 meeting we assumed that clarifying the scope and the interaction between IFRS 3, IAS 27, IAS 28, IAS 31 and SIC-13 and developing consistent principles for status changes between subsidiaries, joint ventures and associates would require a broad review of the interaction of the principles underlying these standards. We thought that such a review would go beyond the scope of the Committee project. Instead, it would require a separate Board project.

39. However, on the subject of the narrow issue of the contribution of a subsidiary to a JCE or associate, we agreed with the submitters that:

    (a) financial reporting would be improved by simply resolving the inconsistency between IAS 27 and SIC-13 for transactions where a parent contributes interests in a subsidiary to a JCE (or to an associate) and this contribution results in a loss of control in the subsidiary for the parent; and

    (b) the IASB could do such a narrow and well-defined amendment in its annual improvements project.

40. Given that the guidance in paragraph 34 of IAS 27 reflects the Board's more recent thinking than is the guidance in SIC-13, we thought that the approach outlined in paragraph 34 of IAS 27 (ie full recognition of gains and losses) should take precedence when a subsidiary is contributed to a JCE and this contribution results in a loss of control in the subsidiary. The partial recognition approach set out in SIC-13 should remain applicable to all the other assets contributed to a JCE.

41. Considering that based on the normal timeline, any annual improvement would not become effective earlier than 1 January 2013, ie when IFRS 11 *Joint Arrangements* and IAS 28 (revised 2011) will become effective, we proposed to amend the forthcoming IAS 28 (revised 2011) instead of current IAS 31/SIC-13.

Interpretations Committee's recommendation to the Board

42. The Committee acknowledged that there is an inconsistency between the guidance in IAS 27 and IAS 31 together with SIC-13 for transactions where a parent contributes interests in a subsidiary to a JCE and this contribution results in a loss of control in the subsidiary by the parent and noted the tentative decisions taken by the Board in its December 2009 meeting.

43. The Committee also noted that there are broader issues in relation to contributions to a JCE or an associate in general, particularly involving the loss of control when a subsidiary becomes a JCE or an associate. The Committee therefore concluded that this issue would be best resolved by referring it to the Board as part of a broader project on equity accounting.

44. The Committee therefore recommends that the Board should not proceed with an annual improvement to address this issue.

Question to the Board

Question 2—Interpretations Committee's recommendation
1. Does the Board agree with the Committee's recommendation not to propose an amendment through Annual Improvements to address this issue? 2. Does the Board agree with the Committee's recommendation that these issues should be considered as part of an agenda proposal for a broader project on equity accounting?

IAS 28 *Investments in Associates*—purchases in stages—fair value as deemed cost

Background information

45. The Committee received a question on how to account for changes from available for sale (AFS) category to equity method for an associate purchased in stages.

46. More specifically the question was of:

(a) the amount the investment in an associate should be initially measured at; and

(b) the accounting for any previously accumulated changes in fair value relating to the investment recognised in other comprehensive income (OCI), at the date significant influence is obtained. At this date, the investment ceases to be categorised as AFS, and is classified as an investment in an associate.

Summary of the staff's analysis

47. The following is a summary of the analysis presented at the Committee's meeting in July 2010. Our full analysis was set out in Agenda paper 16, which can be found on the public website.

48. We split our analysis into two issues:

(a) Issue 1: the amount the investment in the associate should be measured at when significant influence is obtained; and

(b) Issue 2: the accounting for the accumulated changes in fair value in OCI when significant influence is obtained.

Issue 1: amount at which the investment in the associate should be measured when significant influence is obtained

49. Different views currently exist:

(a) View A: paragraph 11 of IAS 28 requires the associate to be recognised at cost. The cost to the investor of its investment, when the investee becomes an associate, is the sum of consideration paid for each purchase plus a share of the investee's profits and other equity movements from the date of each purchase to the date of obtaining significant influence; or

(b) View B: cost should reflect 'cost' at the date the investor obtains significant influence over the investee. The fair value of the pre-existing interest at the date of obtaining significant influence is the 'deemed cost' of that portion.

50. We see merits in both views and acknowledge that paragraphs 11 and 20 of IAS 28 may be perceived as providing conflicting guidance.

51. In our opinion, when the investment is classified as AFS prior to the investor obtaining significant influence over the investee, applying view A would lead to unduly onerous goodwill calculations. Consequently, we support view B.

52. We believe that clarifying that fair value is the 'deemed cost' of the investment - previously classified as an AFS—at the date the investor obtains significant influence over the investee—would be an improvement that would enhance consistency (similarity to IFRS 3), simplify financial reporting and reduce diversity in practice.

Issue 2: accounting for the accumulated changes in fair value in OCI when significant influence is obtained

53. We observe that some are of the view that obtaining significant influence over the investee is only a reclassification event; the investor reclassifies its investment from AFS to an investment in an associate. In their view, nothing of significance has happened to affect the existing investment. Consequently, in their view, that reclassification should not affect profit or loss for the period.

54. We do not support this approach because we do not see a rationale for continuing to report an AFS component in OCI that is no longer attached to an AFS instrument. In addition, this would give rise to reporting difficulties in practice: the OCI component would have to be closely monitored to remain linked to the investment in the associate with a view to reclassifying it to profit or loss it in the event of a sale or of an impairment of the investment.

Interpretations Committee's recommendation to the Board

55. The Committee acknowledged that there is diversity in practice in accounting for associates purchased in stages.

56. The Committee disagreed with addressing the issue through Annual Improvements because it did not think that it would be able to reach a consensus on a timely basis.

57. However, because of the acknowledged diversity in practice, the Committee recommended that the issue should be referred to the Board for consideration.

58. Consequently, the Committee recommends that the Board should not address this issue through Annual Improvements; rather it should consider addressing the issue in another way, perhaps along with other issues that have been raised relating to the equity method of accounting.

Question to the Board

Question 3—Interpretations Committee's recommendation
1. Does the Board agree with the Committee's recommendation not to propose an amendment through Annual Improvements to address this issue? 2. Does the Board agree with the Committee's recommendation that these issues should be considered as part of an agenda proposal for a broader project on equity accounting?

IAS 28 *Investments in Associates*—equity method

Background information

59. The following is a summary of the analysis presented to the Committee in May 2011. Our full analysis was set out in Agenda paper 14, which can be found on the public website.

60. In March 2011 the Committee received a request to correct an unintended inconsistency between the requirements of paragraphs 2 and 11 of IAS 28 *Investment in Associates* and IAS 1 *Presentation of Financial Statements* (revised 2007) regarding the description and application of the equity method.

61. The definition of equity method in paragraph 2 of IAS 28 indicates that all changes in the net assets of an investee should be recognised by the investor. However, the submission notes that IAS 28.11 specifies the accounting of the investor's share of profit or loss, distributions and other comprehensive income but is silent on the accounting for other changes in the investee's net assets when the investor applies the equity method. This is because paragraph 11 no longer states **whether** and **where** the investor should account for its share in those changes. Such changes might include:

(a) movements in other reserves of the associate (eg share-based payment reserves);

(b) gains and losses arising on an associate's transactions with non-controlling interest of its subsidiaries; and

(c) liabilities recognised in respect of put options to non-controlling interests.

62. The submitter asserts that this inconsistency arose when IAS 1 made a consequential amendment to IAS 28.11 as part of the 2007 revision to IAS 1.

63. The submission recommended an improvement to the wording of IAS 28.11 and requested the Board to address this issue as part of the annual improvements project.

64. The submission discussed four possible views on how to account for the investor's share in the changes in the investee's net assets that are not part of the investee's profit or loss, other comprehensive income and that do not represent distributions (hereafter referred to as 'investee's other changes in net assets'). The four views were to recognise these investee's other changes in net assets either as equity, as part of other comprehensive income (OCI), or as part of profit or loss, or not recognise this transaction at all.

65. The submitter supports the recognition in the investor's profit or loss of 'all other transactions of the investee that adjust the net assets of the investee without adjusting the investor's proportionate share in the net assets' because:

(a) it would eliminate any conflict with the guidance in IAS 1 that establishes the segregation of all owner and non-owner changes in the financial statements; and

(b) the investor's share in the investee's other changes in net assets is not an OCI item in accordance with the definition of OCI.

Summary of the staff's analysis

66. We agree that the current wording in paragraph 11 in IAS 28 is reflecting only part of the mechanics of the equity method and is omitting all the investee's other changes in net assets that should be recognised by the investor under the definition of the equity method in paragraph 2. We think that IAS 28.11 should be made consistent with the

definition of equity method in IAS 28.2 to explicitly refer to adjustments to the carrying amount of an investment in associate arising from all changes in the investee's net assets.

67. In addition, the staff agrees with the submitter that the split between owner and non-owner changes mandated by IAS 1 (revised 2007) and the definition of what should be included within changes in equity compared with profit or loss or OCI, precludes these other changes in net assets from being recognised within the investor's owner changes in equity.

68. Consequently, we think that those changes should be recognised as part of the investor's non-owner changes in equity (total comprehensive income) within the investor's OCI because we think that that the list of OCI components in IAS 1 is not exhaustive. In addition, we could not find any evidence that the Board intended to change equity accounting for OCI and other changes in equity from the investor's perspective when the Board revised IAS 1.

Interpretations Committee's recommendation to the Board

69. Even though the Committee members acknowledged that the recognition of the investor's share of the other changes in the investee's net assets is a problem that arises in practice, they disagreed with the staff's proposed accounting treatment. In their view, OCI is not considered a residual change in net assets and instead they think that IAS 1 contains a clear list of items of income and expense that other standards have precluded from being recognised in profit or loss; consequently, only those items of income and expense that other IFRSs require or permit to be recognised outside profit or loss should be recognised in OCI.

70. Most Committee members think that the default for recognising items of income and expense should be, instead, profit or loss. However, most Committee members think that the proposed accounting treatment would not faithfully represent the economic substance of the associate's transactions in the investor's financial statements. In their view, there is a need for a wider examination of specific transactions on a case-by case basis, such as, the accounting from the investor's perspective, of transactions with non-controlling interests of an associate's subsidiaries, and the accounting for share-

based payments by an associate. In the view of the Committee members, the analysis of such changes would be better suited to being considered by the Board as part of a broader project to address other issues that have been brought to the Board's attention relating to IAS 28.

71. Consequently, the Committee recommends that the Board should not address this issue through Annual Improvements.

Question to the Board

Question 4—Interpretations Committee's recommendation
1. Does the Board agree with the Committee's recommendation not to propose an amendment through Annual Improvements to address this issue? 2. Does the Board agree with the Committee's recommendation that these issues should be considered as part of an agenda proposal for a broader project on equity accounting?