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cutting through complexity

Proposal to amend equity accounting

A new rule seeks consistency

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IN THE HEADLINES

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> “Of course a rule would provide consistency, but is it the best answer in all cases?”
>
> – Paul Munter, KPMG’s global IFRS business combinations and consolidation leader

Lack of clarity in accounting for changes in ‘other' net assets

It is currently unclear how an investor should account for some changes in the net assets of an equity-accounted investee that are recognised directly in equity by the investee (‘other’ net assets).

In response to this lack of clarity, on 22 November 2012 the IASB issued Exposure Draft *Equity Method: Share of Other Net Asset Changes* (the ED).

A new rule seeks consistency

The ED proposes a rule that would provide consistency by requiring the effect of changes in other net assets of the investee to be recognised directly in equity by the investor, as shown in the diagram.

Such amounts recognised directly in equity would be reclassified to profit or loss when equity accounting is discontinued – e.g. on disposal of the investment.

Simplicity vs substance

The proposal seeks to impose a rule that would be very simple to apply, with the IASB noting that changes in other net assets are unrelated to the investee’s performance. However, the trade-off is whether the underlying accounting is appropriate in relation to the substance of the transaction. The following example illustrates the dilemma.

Fact pattern

- An associate issues shares to a third party for cash.
- As a result, its net assets increase from 100 to 140.
- The investor’s interest goes from 30% to 25%.

Effect of dilution

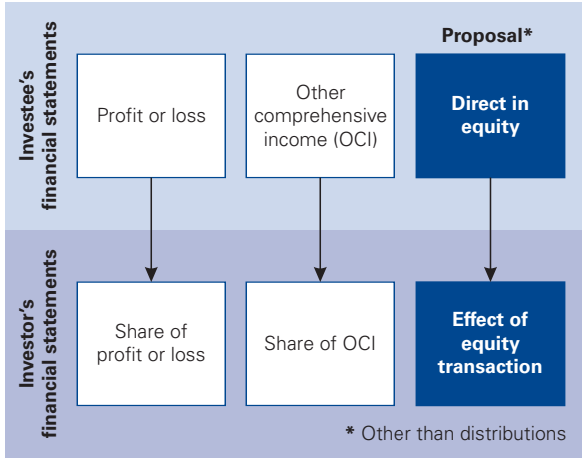
- Interest before share issue: 100 x 30% = 30.
- Interest after share issue: 140 x 25% = 35.
- Therefore, dilution gain: 35 - 30 = 5.

Proposal

- Gain recognised directly in equity.

What’s your view?
The dilution reflects the investor’s performance... So would it be more appropriate to recognise the gain in profit or loss?

The rule has been devised to add simplicity to complex cases – e.g. an associate’s transactions in derivatives over its or its group’s own equity. But would it produce an unsatisfactory answer for some simple cases? One member of the IASB objected to the proposal on precisely these grounds, noting that it confuses investor group equity with investee equity. Constituents should consider this point in responding to the proposal, whose comment period ends on 22 March 2013.



Adoption

The ED does not propose an effective date, but indicates that early adoption would be allowed. Retrospective application is proposed.

Find out more

For more information on the ED, please go to the IASB press release or speak to your usual KPMG contact.

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