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MFRS Hot Topics

Share-based payments of an associate

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue will provide guidance on how and when should the investor record a change in its ownership interest when an associate (investee) issues new shares under a share-based payment scheme.

Contents

1 Introduction

2 Discussion

Introduction

An issue of new shares by an associate, for example on exercise of options granted in a share-based payment arrangement, will (usually) increase the associate's net assets but reduce the investor's percentage ownership interest. This will increase or decrease the investor's share of net assets (unless the proceeds per share exactly equals the net assets per share of the associate).

MFRS 128 Investments in Associates and Joint Ventures is clear that if the change results in the investment ceasing to be an associate and becoming a financial asset, then the investor recognises in profit or loss any difference between the fair value of any retained investment plus any sale proceeds from the part disposal and the carrying value of the investment at the date the equity method was discontinued (MFRS 128.22(b)). Also, the investor reclassifies its share of any gains or losses the investee's previously recognised through other comprehensive income to profit or loss (MFRS 128.22(c)). Further, MFRS 128.24 states that when an investment in an associate becomes an investment in a joint venture (or vice versa), the investor continues to apply the equity method and does not remeasure the retained interest.

MFRS does not directly address how to reflect this change in ownership interest when significant influence is retained in the financial statements of the investor. Our preferred view is that this increase or decrease should be recorded in profit and loss in the investor's financial statements with a corresponding adjustment to the carrying value of the associate.

However, this is a matter of interpretation and so other treatments may be possible. The investor should make an accounting policy choice to report the increase or decrease either in equity or profit/loss, since MFRS is not explicit on this issue. This accounting policy should be applied consistently.

Discussion

MFRS 2 Share-based Payment specifies the financial reporting by an entity when it undertakes a share-based payment transaction. The required reporting depends on the type of share-based payment arrangement but the main principle of MFRS 2 is that goods or services received in a share-based payment arrangement are recognised when the goods or services are received. For transactions with an entity's employees to be settled in the entity's own equity instruments (employee share scheme), MFRS 2 requires an expense to be recognised, calculated in most circumstances as the fair value of the award at the date of grant. The expense is recognised in the income statement over the vesting period of the award (if any) and the share option credited to equity.

Where awards are granted in the form of options, employees will typically exercise some or all of their options after vesting. On exercise the employee pays the exercise price and receives shares. The exercise proceeds are credited to equity (with a debit to cash).

MFRS 128 requires that an investment in an associate is accounted for under the equity method except in limited circumstances (MFRS 128.16 and 17). Under the equity method, 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…" (MFRS 128.3). The investor will therefore include its share of the associate's profit or loss including its share of the associate's MFRS 2

"Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised in the investor's other comprehensive income (see MFRS 101 "Presentation of Financial Statements')."

MFRS 128.10 explicitly deals with changes in the carrying amount of the investment due to the investee's profits or losses, dividend distributions and changes in other comprehensive income but does not provide explicit guidance on accounting for other transactions (eg share issuance by the investee) that affects the investor's proportionate share of the investee.

However, MFRS 128.22 and 23 discuss how an investor accounts for its investment when it discontinues the use of the equity method. In that situation, the investor recognises in profit or loss any difference between the fair value of any retained investment plus any sale proceeds and the carrying value of the investment at the date when the investment ceases to be an associate or a joint venture.

Although this is not the situation covered by this MFRS Hot Topic, MFRS 128.25 includes provisions that suggest that a similar treatment is intended for part disposals (or deemed disposals) when the proportionate interest is decreased but significant interest is retained. MFRS 128.25 states: " . . .If an entity's ownership interest in an associate or a joint venture is reduced, but the entity continues to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities".

This can be interpreted such that all dilution gains and losses resulting from changes in the investee's equity should be recorded in profit or loss rather than equity or other comprehensive income. This is our preferred view but other views may also be acceptable. Management judgement is needed to develop an acceptable accounting policy for this type of transaction in accordance with the general principles of MFRS 128 and MFRS 108 Accounting Policies, Changes in Accounting Estimates and Errors.

MFRS 128.12 requires that the investor's share of profit or loss and changes in equity of the associate are based on present ownership interests and are not affected by the possible exercise or conversion of potential voting rights except when an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest (MFRS 128.13). Hence the issue of shares by the associate is generally accounted for when it takes place, not when options over the shares are issued.

Example

An investor acquires 250 shares in a company with a total issued share capital of 1,000 shares on 1/1/X0. The investor determines that the investee in an associate in accordance with MFRS 128. Cost is CU800, and the fair value of the investee's net assets is CU2,000. Hence on acquisition the investor records the investment at CU800, comprising:

	CU
Goodwill	300
Share of net assets (CU2,000*25%)	500
Total	**800**

For the year-ended 31/12/X0 the associate generates net profits of CU1,000, increasing its net assets to CU3,000. The investor's carrying amount is increased to CU1,050 [800 + 1,000*25%] at 31/12/X0.

At 1/1/X1, the associate issues 250 share options to its employees, which can be converted into 250 shares. The exercise price of each option is CU2. The grant-date fair value of each option issued is CU1 and the vesting period is 2 years. The total grant-date fair value of the options issued is CU250 (250 x CU1). All 250 options are expected to vest.

The associate recognises share-based remuneration expense of CU125 in profit or loss and an offsetting credit to equity for the year-ended 31/12/X1. The investor recognises its share of the share-based remuneration expense in profit or loss as part of income from equity method investments but records the offsetting credit as a reduction of its investment. Assuming no other profit or loss items for the year-ended 31/12/X1, and ignoring any tax effects (with the effect that the associate"s net assets are unchanged from 1/12/X1), the entries are as follows at 31/12/X1:

Associate's Entry	Debit	Credit
Share-based payment remuneration	CU125	
Shareholder's equity		CU125

Investor's Entry	Debit	Credit
Share of profit or loss of associate (25%*125)	CU31.25	
Investment in associate		CU31.25

At the end of the vesting period, 12/31/X2, all options vest. In 20X2, the associate generates net profits of CU875 (comprising CU1,000 less the share-based payment charge of CU125). It records the following entry:

Associate's Entry	Debit	Credit
Share-based payment remuneration	CU125	
Other net profits		CU1,000
Cash	CU500	
Other net assets	CU1,000	
Shareholder's equity		CU625

Investor's Entry	Debit	Credit
Share of profit or loss of associate (25%*875)	CU218.75	
Investment in associate		CU218.75

The exercise of the share options results in the dilution of the investor's interest in the associate.

Dilution calculation	CU
Investor's share of associate's net assets before exercise (25% X CU4,000)	1,000
Change in investor's ownership interest (25% - (250 / (1,000 + 250)	5%
Investor's share of associate's net assets after exercise (20% X (CU4,000 + CU500))	900
Cumulative adjustment required*	**100**
Less adjustment previously recognised for share-based payment expense (2 years X CU31.25)	62.50
Loss on dilution	**37.50**
Cumulative adjustment calculation*	
Net assets lost = CU4,000 X 5%	200
Share of proceeds on exercise of options (CU500 X 20%)	100
Cumulative adjustment required*	**100**

The investor's accounting entry to record the dilution loss is:

Investor's Entry	Debit	Credit
Share of profit or loss of associate	CU37.50	
Investment in associate		CU37.50

In future periods the investor will recognise 20% of the associate's profit or loss and gains or losses recognised through other comprehensive income.

KUALA LUMPUR

Level 11, Sheraton Imperial Court
Jalan Sultan Ismail
50774 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828
E info.pg@my.gt.com

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126
E info.ktn@my.gt.com

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 1848
F +607 224 9848
E info.jb@my.gt.com

www.gt.com.my