March 22, 2013

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"

The Corporate Reporting Users' Forum Japan(CRUF J) welcomes the opportunity to provide comments on the Exposure Draft "Equity Method: Share of Other Net Asset Changes" Proposed amendments to IAS 28. CRUF J was established in Tokyo in December 2009, and has been holding monthly meetings since then. Currently the members count 18, which include buy-side and sell-side equity analysts, credit analysts and portfolio managers.

Question 1

＜Majority opinion of CRUF J members＞

- A majority of CRUF J members propose that an investor should recognise the investee's other net asset changes in OCI, rather than in equity

＜Other net asset changes of an investee do not result from transactions with owners and are not equity transactions＞

- As pointed out in paragraph BC8, under the equity method, owners of an investee, other than the investor, are outsiders for the consolidated group, and their equity interest is not the investor's equity. That is, other net asset changes of the investee do not arise from transactions with owners and are not the investee's equity transactions. Accordingly, we think it inappropriate that such changes are recognised in the investor’s equity.

＜Meanwhile, it is also misleading that an investor recognises its share of other net asset changes in the investor’s profit or loss＞

- Meanwhile, the alternative view -- that an investor should recognise its share of other net asset changes in the investor’s profit or loss rather than in equity -- looks unreasonable. The reason is, as explained in paragraph BC4, that this risks giving a misleading representation of the investee’s performance.
- An investor (reporting entity) is considered to preserve certain influence on the equity-method investee for purposes other than pure investment. Thus, as indicated in question 2(with which we agree), the investor should refrain from reclassifying to profit or loss the amount that it had previously recognised in equity, until the investor discontinues the use of the equity method.

＜We think it appropriate to use OCI as a home for other net asset changes＞

- Thus, we propose the view that other net asset changes that are not equity transactions should be recognised in the investor’s OCI. In just such a case, as pointed out in paragraph AV8, we think it appropriate to use OCI as a temporary “home” for such other net asset changes in a way to adjust accumulated OCI.
- In addition, as indicated in question 2 (with which we agree), an investor shall reclassify to profit or loss the cumulative amount of equity that the investor had previously recognized, when the investor discontinues the use of the equity method. In this case, we envision an accounting treatment that reclassifies OCI to profit or loss (recycling). This kind of procedure is found in other accounting standards.
- By contrast, reclassifying the amount that had previously been recognised in equity to profit or loss, as proposed in the Exposure Draft, risks causing confusion about the distinction between equity and profit or loss, and in this sense too, we do not agree with the view proposed in the Exposure Draft that other net asset changes of the investee are the investee’s equity transactions.

＜Minority opinion of CRUF J members＞

- <u>A minority of CRUF J members agree with the view proposed in Question 1</u>

- When we think about valuation from a stock investment perspective, this boils down to the question whether we consider an equity-method investee as a part of the investor’s business and value the equity-method investee from a business investment standpoint, or we recognise gains/losses and mark to market from a pure investment point of view.

- Considering most parent companies are not actively involved in the management of their equity-method affiliate companies in Japan, a valuation from a pure investment perspective seems more reasonable. However, this risks causing a contradictory problem that the equity method is used for pure investment. It is not clear whether applying the equity method for a modest 20-30% ownership investment should be regarded as equivalent to business investment(an operating asset), or as pure investment that should be deducted from enterprise value, when we calculate stock valuation. Corporate reporting users are divided over this issue. Meanwhile, in the case of a strategic equity-method investee, we think it reasonable that even a 49%-held joint-venture is included in operating assets, as the parent company's commitment to business investment is clear despite the non-consolidation of the joint-venture. In other words, we think it appropriate to include the joint-venture investment in invested capital, or consider it as capital contribution, when performing stock valuation.

- In the case of equity method, unlike that of pure investment, an investor exercises certain influence on the investee, though weaker than control under consolidation. That is, the investee's net asset changes that are recognised in profit or loss or OCI cause corresponding changes in the investor's share of the investee's net assets. Similarly, the investee's equity transactions should be recognised in the investor's equity.
- Accordingly, we agree with the explanation, as pointed out in paragraph BC4, that equity transactions do not represent the investee's performance, and we also agree with the explanation, as pointed out in paragraph BC6, that equity method accounting is a one-line consolidation.
- As an example, we assume that an investor has a 30% investment in an investee, which is often the case in Japan. Assuming that the equity-method investee's net assets are 100 and that its ROE is 10%, the expected return is 3(=profit 10 multiplied by equity interest 30%) and the equity is 30. The investee issues additional shares (=40) to a third party and its net assets increase to 140. As a result, the investor's share decreases to 25%. If the increase of 5 in the investee's equity transactions 35(=140×25％) is recognised in profit or loss, the ROE is overvalued as it improves spectacularly to 26.7%(=(3＋5)/30). Thus, recognizing such increase in OCI makes fair valuation difficult due to a big noise, overestimating the underlying earning power, and misleads financial statement users. As the investee's equity transactions increase the invested capital, we think it reasonable to reflect such an increase in the investor's equity method investment, which serves as a base for valuation.
- As is shown in Question 2（with which we agree）, the difference realized upon subsequent sale is considered as gains/losses and is clearly identifiable as such and analytically classifiable.

Thus, we do not think this is a big impediment, even compared to the above-mentioned issues.

- Assuming that an investee raises capital at a premium to its net asset value, and that we evaluate the financial health of the investor on a consolidated basis, including equity-method investees that assume certain influence and risk, we think the impact of the transaction (capital raising) is most faithfully reflected in consolidated balance sheet through the equity method.
- When we examine the investor–investee relationship, the most important point is to look at the capital invested in the business and its return. In this context, we think the accounting treatment based on “the recognition in equity” is more useful than that based on “the recognition in profit or loss” (the accounting method based on indirect sales) to capture the capital efficiency of the group companies.

Question 2 If an investor recognises the investee’s other net asset changes in the investor’s equity, we agree with Question 2, based on the view expressed in paragraph BC10.

Question 3 Regarding the proposals, we feel the conclusions are stated without sufficient conceptual discussions on the distinction between “the recognition in equity” and “the recognition in profit or loss.” We should start by having conceptual discussions.

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

Yours sincerely,

(Signature)

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