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Comments on Exposure Draft "Equity Method of Accounting – IAS 28 Investments in Associates and Joint Ventures (revised 202x)"

Dear Madam, dear Sir,

On behalf of the Austrian Financial Reporting Advisory Committee (AFRAC), the privately organised standard-setting body for financial and other corporate reporting in Austria, we appreciate the opportunity to comment on the Exposure Draft “Equity Method of Accounting – IAS 28 Investments in Associates and Joint Ventures (revised 202x)".

Principal authors of this comment letter were Ulf Kühle, Roland Nessmann, Gerhard Prachner, and Anita Seiwald (chair). In order to ensure a balanced Austrian view on the consultation, these authors have different professional backgrounds.

Best regards,
Romuald Bertl
Chairman

Comments on Exposure Draft "Equity Method of Accounting – IAS 28 Investments in Associates and Joint Ventures (revised 202x)"

General comments

We appreciate the efforts of the IASB to clarify selected application questions related to the equity method. We understand that the IASB gave preference to that approach instead of performing a fundamental review and revision of the equity method in order to be able to provide solutions to these application issues in a shorter time. However, we believe that the main conceptual issue whether the equity method is a consolidation or a measurement method remains unsolved. Having a clear answer to this question would support the development of appropriate solutions to application questions. Thus, we see the benefit of a fundamental review of the equity method and recommend that the IASB adds such a project to its agenda.

In spite of this fundamental concern, we comment on the Exposure Draft. We agree with some of the changes proposed as they will remove diversity in practice and inconsistencies with other IFRS. However, we are critical of some proposals, mainly the treatment of the acquisition of additional ownership interests and other changes in ownership interests while retaining significant influence, removing the '"significant or prolonged" decline in fair value' criterion, and the disclosure requirements. We provide our position on the individual proposals of the Exposure Draft in the detailed responses to the questions below.

As in the IASB's questions for respondents, we answer all questions in relation to investments in associates. References to 'investor', 'associate' and 'significant influence' should be read as also referring to 'joint venturer', 'joint ventures', and 'joint control' in relation to investments in joint ventures.

Question 1—Measurement of cost of an associate (Appendix A and paragraphs 13, 22, 26 and 29 of [draft] IAS 28 (revised 202x))

Paragraph 32 of IAS 28 requires an investor that obtains significant influence to account for the difference between the cost of the investment and the investor's share of the net fair value of the associate's identifiable assets and liabilities either as goodwill (included in the carrying amount of the investment) or as a gain from a bargain purchase (recognised in profit or loss). However, IAS 28 does not include requirements for how an investor measures the cost of the investment on obtaining significant influence—for example:

- *(a) whether to measure any previously held ownership interest in the associate at fair value; or*
- *(b) whether and if so how to recognise and measure contingent consideration.*

The IASB is proposing an investor:

- *(a) measure the cost of an associate, on obtaining significant influence, at the fair value of the consideration transferred, including the fair value of any previously held interest in the associate.*

(b) recognise contingent consideration as part of the consideration transferred and measure it at fair value. Thereafter:
   (i) not remeasure contingent consideration classified as an equity instrument; and
   (ii) measure other contingent consideration at fair value at each reporting date and recognise changes in fair value in profit or loss.

Paragraphs BC17–BC18 and BC89–BC93 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 1:

We agree with the approach to measure the cost of an associate, on obtaining significant influence, at the fair value of the consideration transferred, including the fair value of any previously held ownership interest and any contingent consideration. In addition, we support the initial and subsequent treatment of the contingent consideration which is in line with the requirements of IFRS 3.

The ED does not specify whether transaction costs should be included in the carrying amount of the investment. The treatment of transaction costs should be dependent on whether the equity method is considered as a measurement basis or as a one-line consolidation. If the equity method is seen as a measurement basis, transaction costs should be added to the cost of the underlying investment. Under the view of the equity method as pure consolidation approach, transaction costs should be treated according to the principles in IFRS 3 and accordingly should be immediately expensed in profit or loss. We recommend that the IASB clarifies which view should prevail. Clarifying the treatment of transaction costs would avoid creating a new source of diversity in practice. As transaction costs for investments in equity instruments are expensed under other standards, i.e. IFRS 9 and IFRS 3, we suggest that this treatment should also be used for investments under IAS 28.

We agree with the recognition of deferred tax on the fair value adjustments recognized on the associate's net assets. This approach ensures a faithful representation of the future tax consequences of the fair value adjustments and is consistent with the principles to be applied for business combinations according to IFRS. Furthermore, this approach is already widely applied in practice.

The ED does not address the question how to perform the investor's cost allocation when the investee is not a business. If the investee is not a business, it would not be appropriate to account for the difference between the cost of the investment and the investor's share of the net fair value of the associate's identifiable assets and liabilities as goodwill or as a gain from a bargain purchase. We recommend clarifying this application question as well.

The ED is silent on whether the possibility to recognize provisional amounts and adjust goodwill during a measurement period of 12 months in line with the provisions of IFRS 3 is also allowed in the context of IAS 28. We recommend that the IASB includes this possibility also in IAS 28.

Question 2—Changes in an investor's ownership interest while retaining significant Influence (Paragraphs 30–34 of [draft] IAS 28 (revised 202x))

IAS 28 does not include requirements on how an investor accounts for changes in its ownership interest in an associate, while retaining significant influence, that arise from:

(a) the purchase of an additional ownership interest in the associate;
(b) the disposal of an ownership interest (partial disposal) in the associate; or
(c) other changes in the investor's ownership interest in the associate.

The IASB is proposing to require that an investor:

(a) at the date of purchasing an additional ownership interest in an associate:
  (i) recognise that additional ownership interest and measure it at the fair value of the consideration transferred;
  (ii) include in the carrying amount the investor's additional share of the fair value of the associate's identifiable assets and liabilities; and
  (iii) account for any difference between (i) and (ii) either as goodwill included as part of the carrying amount of the investment or as a gain from a bargain purchase in profit or loss.

(b) at the date of disposing of an ownership interest:
  (i) derecognise the disposed portion of its investment in the associate measured as a percentage of the carrying amount of the investment; and
  (ii) recognise any difference between the consideration received and the amount of the disposed portion as a gain or loss in profit or loss.

(c) for other changes in its ownership interest in an associate:
  (i) recognise an increase in its ownership interest, as if purchasing an additional ownership interest. In (a)(i), 'the fair value of the consideration transferred' shall be read as 'the investor's share of the change in its associate's net assets arising from the associate's redemption of equity instruments'.
  (ii) recognise a decrease in its ownership interest, as if disposing of an ownership interest. In (b)(ii) 'the consideration received' shall be read as 'the investor's share of the change in its associate's net assets arising from the associate's issue of equity instruments'.

Paragraphs BC20–BC44 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 2:

Purchase of an additional ownership interest

We agree with the proposal that previously held interests are not remeasured at fair value when an investor purchases an additional interest in an associate and with the reasons underlying this proposal summarized in BC23.

The ED further proposes that each additional acquired ownership interest is treated while retaining significant influence as a separate unit of account. It follows from this that the investor must perform at the acquisition date for each additional interest a purchase price allocation (PPA) in which the investor's additional share of identifiable assets and liabilities is measured at fair value. Any difference between the consideration transferred and the additional share of net assets measured at fair value is accounted for as goodwill or bargain purchase gain. We understand this approach from a conceptual point of view. But we have significant concerns about the application of this approach in practice. Performing a separate, complete PPA for each additional purchase of interests leads to a significant burden for preparers. It will often be difficult for investors and joint venturers to receive all the information required to perform the PPA including the identification and valuation of all identifiable assets and liabilities of associates and joint ventures.

In addition, this approach will require a separate subsequent accounting for each layer of ownership interest. This means that the additional burden is not limited to the initial recognition of the additional layer but continues during the subsequent accounting of the investment, which will especially be complex for associates with frequent changes in ownership interests. We would also like to point out that this layered approach will lead to a disproportionate accounting burden for increases of ownership interests in associates in comparison to fully consolidated entities according to IFRS 3.

Overall, the proposed approach will lead to a significant increase of the cost for the preparation and the audit, especially in case of participations with frequent changes in ownership interests. We, therefore, strongly recommend the IASB to reconsider this proposal. While we principally agree with treating each layer separately, we are of the opinion that the accounting requirements must be simplified to achieve a fair balance of costs and benefits.

EFRAG presents in its Draft Comment letter two alternative approaches. Under alternative 1, EFRAG suggests using PPA-related information that was applied while obtaining significant influence. We agree that this approach would alleviate the burden from applying the layered approach. But we doubt that it would be suitable for cases in which significant influence had been obtained many years ago.

Under the second EFRAG alternative approach, no PPA would be required. It is instead assumed that the investor's share of the fair value of net assets related to the acquired additional ownership interest would be equal to the fair value of the consideration transferred by the investor. While this approach would be a significant simplification, it is not clear to us how the subsequent accounting of the additional ownership interests would be performed. We propose to explore in more detail how this model could be implemented in practice.

The Exposure Draft includes the proposal to not permit the offsetting of a gain on bargain purchase against previously recognized goodwill but to recognize the difference in profit or loss. We agree with this approach which is consistent with the layered approach.

Disposal of an ownership interest

We generally support the proposed approach for partial disposals. This approach is based on the view that an investment is a single unit of account. We agree that this approach reflects how an investment in an associate is usually managed, this approach is more understandable, and less complex and costly to apply than a layered approach.

However, we would like to point out that this approach is not consistent with the approach proposed for the acquisition of interests. There can be cases in which additional interests in an associate are acquired and soon afterwards these additional interests will be disposed of. The inconsistency between the treatment of the acquisition and the disposal can lead to distorting result impacts. In such a situation, it would be more appropriate to apply a layered approach also concerning the disposal. In addition, there are other situations in which a separate part of the investment can be separately identifiable and, therefore, this separate part should be derecognized. This is for example the case when interests in the same associate are held by two or more subsidiaries and one of these subsidiaries disposes of its interests. In this situation, the derecognition of the identifiable interests in this specific subsidiary would reflect the substance of the transaction. Moreover, the application of the approach as proposed in the ED would be complex and costly to apply, since the parent's and the subsidiary's accounts would differ for the retained investment in the associate. We, therefore, suggest that exceptions to the general approach proposed are defined and included in the final amended standard.

Other changes in the investor's ownership interest

We do not agree with the proposal to treat other changes in investor's ownership interests in the same way as acquisitions of additional interests or partial disposals. The issue or redemption of shares by an associate can lead to changes in the ownership interest without an exchange transaction with the investor. We do not agree that these other changes in ownership interests without an exchange transaction have the same quality as acquisitions and disposals of ownership interest. In addition, the requirement to perform a separate PPA for other increases in interests is overly burdensome (see section "Purchase of an additional ownership interest" above). Even if we generally appreciate the clarification of application questions, we think that this proposal is not adequate and, therefore, should not be included in the final revised standard.

Question 3—Recognition of the investor's share of losses (Paragraphs 49–52 of [draft] IAS 28 (revised 202x))

Paragraph 38 of IAS 28 requires that if an investor's share of losses equals or exceeds its interest in the associate, the investor discontinue recognising its share of further losses. However, IAS 28 does not include requirements on whether an investor that has reduced the carrying amount of its investment in an associate to nil:

(a) on purchasing an additional ownership interest, recognises any losses not recognised as a 'catch up' adjustment by deducting those losses from the cost of the additional ownership interest; or

(b) recognises separately its share of each component of the associate's comprehensive income.

The IASB is proposing an investor:

(a) on purchasing an additional ownership interest, not recognise its share of an associate's losses that it has not recognised by reducing the carrying amount of the additional ownership interest.

(b) recognise and present separately its share of the associate's profit or loss and its share of the associate's other comprehensive income.

Paragraphs BC47–BC62 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 3:

Losses not recognised and purchase of an additional interest

We considered the proposed approach to not recognize a 'catch up' of unrecognised losses when additional ownership interests in the associate are purchased. We agree with this approach which is consistent with treating each additional ownership interest as a separate layer.

Recognition of each component of comprehensive income

We support the proposal that when an investor has reduced the carrying amount of its investment in an associate to nil, the investor shall recognise and present separately its share of the associate's profit or loss and its share of the associate's other comprehensive income. But there are related application questions, such as the order of recognising profits in profit or loss and in other comprehensive income when an investor resumes recognising its share of the associate's profits. We are of the opinion that the IASB should also address these additional questions, even if they are rare in practice as stated in BC62.

Question 4—Transactions with associates (Paragraph 53 of [draft] IAS 28 (revised 202x))

Paragraph 28 of IAS 28 requires an investor to recognise gains and losses resulting from transactions between itself and an associate only to the extent of unrelated investors' interests in the associate. This requirement applies to both 'downstream' transactions (such as a sale or contribution of assets from an investor to an associate) and 'upstream' transactions (such as a sale of assets from an associate to an investor).

If an investor loses control of a subsidiary in a transaction with an associate, the requirement in IAS 28 to recognise only a portion of the gains or losses is inconsistent with the requirement in IFRS 10 to recognise in full the gain or loss on losing control of a subsidiary.

The IASB is proposing to require that an investor recognise in full gains and losses resulting from all 'upstream' and 'downstream' transactions with its associates, including transactions involving the loss of control of a subsidiary.

Paragraphs BC63–BC84 of the Basis for Conclusions explain the IASB's rationale for this proposal.

Do you agree with this proposal?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 4:

We agree with the ED's proposal to recognize in full gains and losses resulting from transactions with associates. This change will lead to a consistent accounting treatment for all transactions with associates. It resolves the application question if an investor sells a subsidiary to its associate (existing conflict between IFRS 10 and IAS 28) and is consistent with the requirements of IFRS 10. We also consider this proposal as a practicable approach which will reduce the burden for preparers.

Nevertheless, we would like to emphasize that the removal of the requirement to eliminate gains and losses from upstream and downstream transactions could increase opportunities for earnings management. We see this mainly as an issue for transactions with joint ventures in which the joint venturers share joint control. Even if the proposed disclosure requirement for gains and losses on downstream transactions would provide a certain transparency on such transactions (see our answer to question 7), we are not convinced that disclosures are an appropriate measure to mitigate opportunities for structuring and earnings management.

Question 5—Impairment indicators (decline in fair value) (Paragraph 57 of [draft] IAS 28 (revised 202x))

Paragraphs 41A–41C of IAS 28 describe various events that indicate the net investment in an associate could be impaired. Paragraph 41C of IAS 28 states that a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is objective evidence of impairment. One of the application questions asked whether an investor should assess a decline in the fair value of an investment by comparing that fair value to the carrying amount of the net investment in the associate at the reporting date or to the cost of the investment on initial recognition.

The IASB is proposing:

(a) *to replace 'decline…below cost' of an investment in paragraph 41C of IAS 28 with 'decline…to less than its carrying amount';*
(b) *to remove 'significant or prolonged' decline in fair value; and*
(c) *to add requirements to IAS 28 explaining that information about the fair value of the investment might be observed from the price paid to purchase an additional interest in the associate or received to sell part of the interest, or from a quoted market price for the investment.*

The IASB is also proposing to reorganise the requirements in IAS 28 relating to impairment to make them easier to apply, and to align their wording with the requirements in IAS 36 Impairment of Assets.

Paragraphs BC94–BC106 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 5:

We welcome the IASB's decision to replace 'cost' with 'carrying amount' in paragraph 41C of the current IAS 28 guidance. Furthermore, we support specifying that the information about the fair value of an investment might be observed from the price paid to purchase additional ownership interest and adding this clarification as part of the objective evidence within the IAS 28 requirements.

Whereas the current IAS 28 states that a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is objective evidence of impairment, the ED proposes to remove 'significant or prolonged'. Although this amendment would bring IAS 28 more in line with the provisions for financial assets in IFRS 9 and for other assets in IAS 36, we are concerned about removing this criterion. It will increase the frequency of impairment testing and will trigger frequent write-downs and reversals and accordingly will increase the burden and cost for preparers. We, therefore, recommend that the IASB reconsiders removing this criterion.

Question 6—Investments in subsidiaries to which the equity method is applied in separate financial statements

Paragraph 10 of IAS 27 permits a parent entity to use the equity method in IAS 28 to account for investments in subsidiaries, joint ventures and associates in separate financial statements.

The IASB is proposing to retain paragraph 10 of IAS 27 unchanged, meaning that the proposals in this Exposure Draft would apply to investments in subsidiaries to which the equity method is applied in the investor's separate financial statements.

Paragraphs BC112–BC127 of the Basis for Conclusions explain the IASB's rationale for this proposal.

Do you agree with this proposal?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 6:

The application of the equity method in separate financial statements is not relevant for Austrian companies, with the exception of a few banks that apply IAS 27 in their regulatory reporting. We, therefore, do not include any comments on this question.

Question 7—Disclosure requirements (Paragraphs 20(c), 21(d)–21(e) and 23A–23B of IFRS 12 and paragraph 17A of IAS 27)

The IASB is proposing amendments to IFRS 12 in this Exposure Draft. For investments accounted for using the equity method, the IASB is proposing to require an investor or a joint venturer to disclose:

(a) gains or losses from other changes in its ownership interest;
(b) gains or losses resulting from 'downstream' transactions with its associates or joint ventures;
(c) information about contingent consideration arrangements; and
(d) a reconciliation between the opening and closing carrying amount of its investments.

The IASB is also proposing an amendment to IAS 27 to require a parent—if it uses the equity method to account for its investments in subsidiaries in separate financial statements—to disclose the gains or losses resulting from its 'downstream' transactions with its subsidiaries.

Paragraphs BC137–BC171 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 7:

We generally support enhancing the disclosure requirements in IFRS 12 for investments accounted for using the equity method.

Considering the proposal to recognise in full the gains and losses from transactions with associates/joint ventures, we understand the intention of the IASB to introduce a mandatory disclosure of gains or losses from 'downstream' transactions with associates or joint ventures. But preparers are not only concerned about the cost and complexity of data collecting for this disclosure requirement but they also fear that they will have to disclose commercially sensitive information such as margins from transactions within their ordinary business activity. It should also be considered that IAS 24 *Related Party Disclosures* already requires comprehensive disclosures on transactions with associates/joint ventures. We, therefore, propose to consider excluding downstream transactions within the ordinary business activity from this disclosure requirement. Furthermore, the level of granularity required should be defined in the final standard and should allow for an aggregated presentation of this information, if the IASB maintains this proposal.

As far as contingent consideration is concerned, we concur with the proposed disclosure requirements which are aligned to the requirements for contingent consideration in IFRS 3 *Business Combinations*. These disclosures are helpful for users to understand the amount, timing, and uncertainty of future cash flows related to contingent consideration.

We also consider the reconciliation between the opening and closing carrying amount of investments accounted for using the equity method as a useful information which should be required by the revised standard. Some companies already include such a disclosure in their group financial statement.

Question 8—Disclosure requirements for eligible subsidiaries (Paragraphs 88(c), 91A and 240A of IFRS 19)

IFRS 19 permits eligible subsidiaries to apply IFRS Accounting Standards with reduced disclosure requirements. It specifies the disclosure requirements an eligible subsidiary applies instead of the disclosure requirements in other IFRS Accounting Standards. As part of developing proposed amendments to the disclosure requirements in other IFRS Accounting Standards, the IASB regularly considers which of those proposed amendments should be included in IFRS 19, based on the IASB's principles for reducing disclosure requirements for eligible subsidiaries.

The IASB is proposing amendments to IFRS 19 to require an eligible subsidiary:

(e) to disclose information about contingent consideration arrangements; and
(f) to disclose gains or losses resulting from 'downstream' transactions with its associates or joint ventures.

The IASB is also proposing an amendment to IFRS 19 to require a subsidiary that chooses to apply the equity method to account for its investments in subsidiaries in separate financial statements to disclose gains or losses resulting from 'downstream' transactions with those subsidiaries.

Paragraphs BC172–BC177 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals?

If you disagree, please explain why you disagree and your suggested alternative, taking into consideration the principles for reducing disclosure requirements for eligible subsidiaries applying IFRS 19 (see paragraph BC175 of the Basis for Conclusions).

AFRAC's response to Question 8:

The application of the equity method in separate financial statements and, therefore, the disclosure requirements according to IFRS 19 are not relevant for Austrian companies. We, therefore, do not include any comments on this question.

Question 9—Transition (Paragraphs C3–C10 of [draft] IAS 28 (revised 202x))

The IASB is proposing to require an entity:

(g) to apply retrospectively the requirement to recognise the full gain or loss on all transactions with associates or joint ventures;

(h) to apply the requirements on contingent consideration by recognising and measuring contingent consideration at fair value at the transition date — generally the beginning of the annual reporting period immediately preceding the date of initial application—and adjusting the carrying amount of its investments in associates or joint ventures accordingly; and

(i) to apply prospectively all the other requirements from the transition date.

The IASB is also proposing relief from restating any additional prior periods presented. Paragraphs BC178–BC216 of the Basis for Conclusions explain the IASB's rationale for these proposals.

Do you agree with these proposals?

If you disagree, please explain why you disagree and your suggested alternative.

AFRAC's response to Question 9:

We support the goal of transparent, comparable financial statements, showing the development of one company over the periods as well as between different companies. Thus, we welcome a reduction of different use in practice as seen in the past.

We, therefore, see the advantage of the requirement to retrospectively recognize the full gain or loss on all transactions with associates or joint ventures and a recognition of any contingent consideration at fair value at the transition date and agree with these proposals.

While the IASB finds evidence for retrospective fair value measurement of contingent consideration convincing, paragraph C8 would only allow the use of determinations of recoverable amounts as determined 'at the date of transition' but not determined 'for the date of transition'. The IASB was worried about the use of hindsight and impracticabilities. Besides any impracticabilities that could arise on both, measurement of contingent consideration and recoverable amount, we do not see significantly different risks for the use of hindsight for both measurements. However, we rather see the inconsistency for the timing of impairment expense under the proposed approach. Therefore, we suggest reconsidering the restrictions for retrospective application in paragraph C8 of IAS 28.

Question 10—Expected effects of the proposals

Paragraphs BC217–BC229 of the Basis for Conclusions explain the IASB's analysis of the expected effects of implementing its proposals. Do you agree with this analysis? If not, which aspects of the analysis do you disagree with and why?

AFRAC's response to Question 10:

We agree with the analysis in BC221. This table shows only the very positive aspects of the expected effects of the proposal. But we are concerned about the complexity and costs of the ED proposals in respect of:

- Acquiring additional ownership interest while retaining significant influence and the new requirement of recognizing the additional interest at fair value, which will require the performance of a purchase price allocation for each acquisition.
- Changes in ownership interests that occur without exchange transactions by the reporting entity.
- Eliminating the significant or prolonged decline in the fair value criterion which could trigger impairment testing to be performed more frequently.
- Disclosure requirements.

For more detailed comments to the above-mentioned items, see our answers to the specific questions.

However, we acknowledge that there are benefits of more complete and clearer requirements that will reduce diversity in practice and increase comparability and transparency.

Question 11—Other comments

Do you have any comments on the other proposals in this Exposure Draft, including Appendix D to the Exposure Draft or the Illustrative Examples accompanying the Exposure Draft?
Do you have any comments or suggestions on the way the IASB is proposing to re-order the requirements in IAS 28, as set out in [draft] IAS 28 (revised 202x)?

AFRAC's response to Question 11

We do not have any additional comments.