POSITION PAPER

ESBG Position Paper to the EFRAG Draft Comment Letter (DCL) on the IASB Exposure Draft (ED) regarding the Equity Method of Accounting

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GENERAL COMMENTS

EFRAG welcomes the opportunity to comment on the EFRAG's Draft Comment Letter in response to IASB's Exposure Draft Equity Method of Accounting IAS 28 *Investments in Associates and Joint Ventures* (revised 202x), issued by the IASB on 19 September 2024 (the "ED").

In general, ESBG welcomes the IASB's efforts and approach in publishing amendments to IAS 28 to address existing application challenges, reduce the existing diversity in practice in the application of IAS 28 requirements, enhance the understandability of these requirements, and increase the comparability of the reported information.

Overall, ESBG supports EFRAG's views and comments, with particular emphasis on the following issues:

- Regarding changes in an investor's ownership while retaining significant influence, ESBG highlights its concerns regarding the requirement to conduct a Purchase Price Allocation (PPA) for each additional ownership layer acquired. Such a requirement could impose significant costs, both in the initial preparation and in the ongoing monitoring and maintenance of the related information.
- Concerning the transition section, ESBG supports the IASB's proposal to retrospectively apply the requirement to recognise the full gains or losses on all transactions with associates or joint ventures.

1. Measurement of cost of an associate or joint venture

Transaction costs

The ED is silent on and does not specify how an investor or joint venturer should account for the transaction costs incurred in acquiring ownership interests. Being consistent with the July 2009 IFRIC update, <u>we support EFRAG recommendation that transactions costs should be included in the carrying amount of the investment.</u> A practical solution could be to include a definition in Appendix A or a description of what is considered the cost of an associate "the cost of an investment in an associate at initial recognition includes all amounts paid or payable or liabilities and any directly attributable expenditures necessary to obtain it".

Recognition of goodwill and bargain purchase gains

ESBG believes that the economic value of the investment is more accurately reflected if bargain purchase gains are first netted against the previously recorded goodwill as the latter ultimately represents the entity's expectations of future gains.

Additionally, we want to highlight that certain goodwill has a negative effect on prudential ratios of banks, making it even more logical to allow for such compensation to present more accurate and representative ratios.

Deferred tax effects

ESBG supports the proposal of requiring to be included in the carrying amount of its investment the deferred tax effects related to measuring its share of the associate's identifiable assets and liabilities at fair value. This proposal is a consequence of measuring the investors share in the associate's identifiable assets and liabilities at fair value and provides a more accurate presentation of the financial effects of obtaining an investment in an associate. ESBG emphasizes the obligation for preparers to monitor these deferred tax effects, given their material relevance, so to register any movements during the reporting periods.

Furthermore, ESBG recognizes that applying the proposed approach may entail certain costs and complexity for preparers, but we believe the benefits to users should outweigh the costs to preparers. As from our understanding, this approach is commonly applied in practice.

2. <u>Changes in an investor's ownership interest while retaining significant influence</u>

Purchase of additional interest while retaining significant influence

In general, ESBG supports EFRAG's position regarding the treatment of each additional interest acquired while retaining significant influence as a separate unit of account, without requiring the remeasurement of the carrying amount of the previously held interest in an associate or joint venture.

ESBG considers adequate for the purchase price allocation (PPA) to be carried out at the point when significant influence is obtained, as outlined in the ED proposal. However, ESBG expresses concern about the requirement to perform a PPA for each additional layer of acquisition as a separate unit of account. The preparation and subsequent monitoring of a PPA for each acquisition may result in considerable complexity and high costs, particularly in cases of step acquisitions involving multiple transactions over time.

ESBG recommends that the cost-benefit of requiring a PPA for each additional acquisition is carefully evaluated and urges the IASB to state explicitly that no PPA is needed for additional layers' acquisitions.

In relation to the alternatives proposed by some stakeholders, ESBG considers the following:

- *Alternative 1 Using PPA-related information that was applied while obtaining significant influence:* ESBG identifies a substantial concern with this alternative, primarily due to the significant degree of professional judgment required for subsequent adjustments. This approach relies on the fair value of the assets and liabilities of the investee (associate or joint venture) as determined at the point when the investor obtained significant influence, with this initial valuation serving as the reference point. Subsequent adjustments would then be made to reflect the proportion of the additional interest acquired. However, in instances where the initial acquisition took place a considerable time ago, such as 10-20 years prior, the complexity involved in obtaining up-to-date information and executing the necessary adjustments could necessitate a high level of judgment and could lead to significant estimation uncertainty.

- *Alternative 2 – No PPA approach*: ESBG supports this alternative as it eliminates the costs associated with the application of a Purchase Price Allocation (PPA) for each new acquisition. This approach simplifies the accounting treatment and reduces the administrative and financial burden related to preparing a PPA for each acquisition.

- *Alternative 3 – No PPA approach adjusted:* ESBG proposes an additional alternative, which is based on Alternative 2, but provides greater flexibility to accommodate specific circumstances. Under this alternative approach, it would initially be assumed that the fair value of the net assets acquired in the additional interest corresponds to the consideration transferred by the investor. However, should the investor possess reliable evidence, such as public information, demonstrating that the fair value of any specific asset deviates from the amount paid or there is a contingent or not liability that should be considered, preparers could use this information to prepare a proxy of a PPA.

Other changes in ownership interest while retaining significant influence

In line with the position expressed by EFRAG in paragraph 57 of the DCL, ESBG suggests excluding from the amendments to IAS 28 transactions and events that are non-exchanged within an investee (associate or joint venture) that result in changes to the investor's interest and/or rights over the investee's resources.

3. Recognition of investor's share of losses

ESBG agrees with EFRAG's recommendation to the IASB about the prohibition of the recognition of additional goodwill when the carrying amount of the investment is nil. The recognition of additional goodwill in situations where the net assets of an investee are already negative would be inappropriate and may distort the faithful representation of economic reality.

4. Transactions with associates and joint ventures

ESBG supports the ED's proposal that requires an investor to fully recognize the gains or losses arising from its "upstream" and "downstream" transactions with its associates and joint ventures.

5. Separate financial statements

General comments

ESBG supports the initial position expressed by EFRAG, which advocates for the consistent application of the equity method to subsidiaries, associates, and joint ventures in separate financial statements. This view aligns with the IASB's perspective, which views an investment in a subsidiary, in the context of separate financial statements, as an asset controlled by the investor (the parent entity) rather than as a business, thereby focusing on the performance of that asset.

ESBG also supports addressing the issues and concerns related to separate financial statements within the scope of a dedicated project on IAS 27, rather than incorporating these matters into the current amendments to IAS 28.

EFRAG question to constituents- separate financial statements

6.1. In your jurisdiction, is the equity method for transactions with subsidiaries applied by companies? If so, is it analogised to IFRS 3 and IFRS 10 requirements (e.g., for transaction costs, and the elimination of gains or losses for transactions with subsidiaries)? Are there significant differences between any of the line items in the separate financial statements versus consolidated financial statements?

In relation to the application of the equity method to transactions involving subsidiaries, it is worth noting that, while it cannot be applied in some of our members' countries (e.g. Spain), it is applied in certain other countries such as Portugal. This practice results in differences between consolidated financial statements and separate financial statements, primarily because transactions with subsidiaries and associates are not eliminated in the latter. Consequently, this can lead to significant discrepancies in the reported results and balances.

6.2. Do you agree with the suggested clarification of the applicability of the equity method principles towards investments that are measured at cost in separate financial statements?

ESBG aligns with EFRAG's position regarding the need for the IASB to explicitly clarify whether the definition of "cost" is consistent across all types of investments, namely subsidiaries, associates, and joint ventures.

6.3 Do you agree with the suggestion for an option to be allowed and a reconciliation required as stated in paragraphs 132 to 134? If not, please explain why.

Regarding the proposal to require a reconciliation explaining the differences between the amounts presented in consolidated financial statements and separate financial statements, ESBG recommends a careful evaluation of the cost-benefit balance associated with preparing such reconciliations. This would ensure that the implementation delivers value to users of financial information while remaining efficient and proportionate in terms of preparers' efforts.

6. Transition

ESBG supports the IASB proposal to apply retrospectively the requirement to recognise the full gains or loss on all transactions with associates or joint ventures. Following the criteria established in IAS 8, an entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented if a reliable estimation can be performed.

EFRAG recommends, in paragraph 178, that previously unrecognised gains and losses form transactions with investees that occurred before the application should be recognised, amortised, or realised and reflected in profit or loss over time. ESBG found it may be complex to determine the period in which you will recognise the profit or loss generated by the transaction in the PL.

For instance, if you have a transaction which provides an associate with exclusive access to a channel and it is instrumented with a contract of which 4 years have already passed and there are still 6 years left, how should we impute it prospectively? From ESBG's perspective, the previous amounts should be recorded against equity, and the following 6 years in each corresponding period. If the preparer cannot make a reliable estimation of the retrospective impact, then we agree that the requirement to recognize the full gains or loss should be applied prospectively; however, we believe that such application conveys much more judgement.

7. Expected effects (cost-benefit balance) of the proposals

ESBG highlights the cost-benefit considerations outlined in previous responses, and agrees with the position expressed by EFRAG.

Furthermore, ESBG wishes to emphasize the potential costs associated with implementing this amendment, particularly concerning IT systems and processes. Adapting and preparing systems to comply with the proposed requirements would pose significant technological challenges for entities, as well as increased associated costs. This impact would be especially pronounced for large corporations managing a high volume of transactions with associates, where the operational complexity and scale would exacerbate the financial and operational challenges of implementation.

About ESBG (European Savings and Retail Banking Group)

ESBG is an association that represents the locally focused European banking sector, helping savings and retail banks in 16 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 871 banks, which together employ 610,000 people driven to innovate at 41,000 outlets. ESBG members have total assets of €6.38 trillion, provide €3.6 trillion billion in loans to non-banks, and serve 163 million Europeans seeking retail banking services.

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