Comments on

Equity Method Exposure Draft issued by IASB

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Question:

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.

Comments:

We do not agree with the proposals in the exposure draft 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 interest in the associate.

Paragraph BC18 of the Basis for Conclusions on the proposals in the Exposure Draft states that the IASB considered that obtaining significant influence changes both the relationship between the investor and the investee and the accounting method used by the investor. In effect, the investor exchanges its previously held financial asset for an investment in an associate.

In an exchange transaction, the asset received is recognised at fair value and the asset given up is derecognised in accordance with the derecognition requirements of the applicable IFRS accounting standards. Therefore, on obtaining significant influence, if the investor had previously held investment in the associate, the investor shall derecognise the existing investment in accordance with IFRS 9 requirements and shall recognise investment in associate at fair value.

The accounting proposal in the exposure draft is not in accordance with IFRS 9 because on obtaining significant influence the rights to the cash flows of the existing investment has expired and the rights to the cash flows of investment in associate has originated. Paragraph 42 of IFRS 3 also requires the existing equity interests in the acquiree to be derecognised. Thus, the existing investment shall be derecognised after remeasuring it at fair value on the date of derecognition in accordance with drecognition of financial asset requirements of IFRS 9 and investment in associate shall be recognised at fair value of the identifiable assets and liabilities of the associate adjusted for deferred tax effects.

Paragraph 24 read with paragraph 25 of the Exposure Draft requires the cost of associate or joint venture to be compared with the share in the fair value of the identifiable assets and liabilities of the associate. Where the cost is higher, the investment is measured at cost and where the share in the fair value is higher, the investment is measured at the share in the fair value of the identifiable assets and liabilities of the associate or joint venture. Thus, the initial measurement of the investment in associate or joint venture is not at cost but at the higher of the following:

a) Cost of the associate; and
b) Share in the fair value of the identifiable assets and liabilities of the associate

The essence of the equity method is that the share in assets, liabilities, income and expenses of the investee is reflected in one line item, investment in associate or joint venture. Paragraph BC35 of the Basis for Conclusions on the proposals in the Exposure Draft states that the IASB considered that investment in an associate is usually managed as a single asset reflected in one line item. The initial measurement at the higher of the two does not follow the essence of the equity method.

Paragraph 57 of the Exposure Draft states that a decline in the fair value of the investment to less than its carrying amount is an indication of impairment. However, paragraph 24 read with paragraph 25 of the Exposure Draft ignores this aspect and considers the excess of the consideration paid over the share in the fair value of the identifiable assets and liabilities of the associate or joint venture as ‘Goodwill’. Any amount paid over and above the fair value of the asset acquired reflects bad will rather than good will. This is a classic example of where loss is being recognised as goodwill without assessing whether the associate or joint venture meets the definition of business. As stated in the paragraph BC35, the investment in associate or joint venture is managed as a single asset. It may be noted that IFRS 3 prohibits recognition of goodwill in case of asset acquisition. Except for acquisition of business and permitted by other IFRS to be recognised as an asset, such as, the difference between the transaction price and fair value on initial measurement of security deposit given to lessor recognised as prepaid rent and include in the cost of right-of-use asset in accordance with IFRS 16, any difference between the transaction price and fair value on initial measurement must be recognised as an income or expense in profit or loss in accordance with paragraph 60 of IFRS 13.

The inclusion of goodwill inflates the carrying amount of the investment in associate or joint venture. Such inclusion is also not in line with principle D mentioned in Table 2 of Basis for Conclusions. The project on goodwill impairment or amortisation emphasised that the overpayment is not a loss but an asset considering the synergies arising out of business acquisition. Under equity method, the accounting does not require the investor or joint venturer to test whether the associate or joint venture is a business. Therefore, any overpayment must be recognised as a loss.

Principle D in Table 2 given in the Basis for Conclusions on the Exposure Draft states that fair value at the date an investor obtains significant influence or joint control provides the most relevant information, and faithful representation of, an associate's or joint venture's identifiable assets and liabilities. Therefore, the initial measurement must be at the share in the fair value of the identifiable assets and liabilities of the associate or joint venture adjusted for deferred tax effects. Any difference between the consideration paid including the fair value of the existing investment including the consideration paid and the share in the fair value of the identifiable assets and liabilities of the associate or joint venture measured at the date the investor obtains significant influence, or the joint venturer obtains joint control adjusted for deferred tax effects shall be recognised in profit or loss.

Cost of the associate has been defined in Appendix A as the fair value of the consideration transferred, including the fair value of any previously held ownership interest (or any investment retained) in the associate or joint venture, measured at the date an investor obtains significant influence, or a joint venturer obtains joint control. The definition is also not in accordance with the IFRS 9 derecognition requirements if the event of obtaining significant influence or joint control is seen as an exchange transaction. The definition of cost of the associate may be reworded as below in Appendix A:

Fair value of the identifiable assets and liabilities of the associate or joint venture measured at the date an investor obtains significant influence or a joint venturer obtains joint control adjusted for deferred tax effects.

From the illustrative example given in the exposure draft we explain below the accounting as per our comments above. It may be noted that the illustrative example is silent on deferred tax on contingent consideration and therefore, we have also not considered the same below. The IASB is requested to also clarify on deferred tax on contingent consideration:

Fair value of existing investment in Entity B is CU1500 on 31 December 20X1. Significant influence is obtained on 1 January 20X2. The illustrative example assumes no change in fair value of exiting investment. Therefore, the fair value of existing investment is CU1500 on 1 January 20X2.

Consideration paid to acquire additional 20% in Entity B on 1 January 20X2 = CU6500.

Carrying amount of net assets of Entity B on 1 January 20X2 = CU20000

Fair Value of the identifiable assets and liabilities of Entity B on 1 January 20X2 = CU30000.

Difference between carrying amount of net assets of Entity B and fair value of net assets of Entity B = CU30000 – CU20000 = CU10000

Share in Fair Value of the identifiable assets and liabilities of Entity B on 1 January 20X2 = CU30000 x 25% = CU7500

Entity B's Tax Rate = 40%

Deferred Tax Effect on Share in the Fair Value of the identifiable assets and liabilities of Entity B on 1 January 20X2 = CU10000 x 40% x 25% = CU1000

Share in the Fair Value of the identifiable assets and liabilities of Entity B net of deferred tax effects on 1 January 20X2 = CU6500

Contingent consideration = CU1000

Initial measurement of investment in associate Entity B on recognition = CU6500 + CU1000 = CU7500

Financial liability for contingent consideration recognised = CU1000

Financial asset derecognised = CU6500 + CU1500 = CU8000

Amount to be recognised in profit or loss on recognition of investment in associate Entity B as per our comments:

Cost of investment in associate Entity B	7500
Less: Cash consideration paid	6500
Less: Contingent consideration financial liability	1000
Less: Fair value of existing investment derecognised	1500
Loss to be recognised in profit or loss	1500

Question:

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.

Comments:

We do not agree with the proposals in the exposure draft to measure the purchase of additional ownership interests as an accumulation of purchases and recognise further goodwill for an asset acquisition or any gain on bargain purchase in profit or loss. The proposal is inconsistent with paragraph 96 of IFRS 10 where the change in ownership interests without loss of control is accounted for as an equity transaction. A transaction that changes ownership interests in subsidiaries also changes the ownership interests in an associate. Once the boundary of the reporting entity has been extended, the same recognition and measurements principles and definitions of elements of financial statements must apply to the extended reporting entity else the conceptual framework need to be amended to specify the principles and definitions of elements of financial statements specifically applicable to the extended reporting entity. IFRS 18 defines owners as holders of claims classified as equity. An investor in an associate or a joint venturer in a joint venture is a holder of claims classified as equity. It needs to be examined by IASB whether accounting is determined based on relationship of entities such as subsidiary or associate or whether accounting is determined based on economics of the transaction. Any change in ownership interests that does not result in loss of significant influence or joint control is a transaction with owners in their capacity as owners and therefore, must be accounted as an equity transaction. The investor or joint venturer would remeasure the investment in the associate or joint venture at the share of the assets and liabilities based on the changed ownership interests plus or minus, as the case may be, the carrying amount of the fair value adjustments on initial recognition. The accounting shall apply to both increase in ownership interests and decrease in ownership interest while retaining significant influence or joint control.

It may be noted that IFRS 11 requires that the joint operation must constitute a business to apply the business combinations accounting. In case of change in ownership interests in associate or joint venture, whether the associate or joint venture constitutes a business is not examined. The equity method recognises the investment as an acquisition of an asset and therefore, equating with the requirements of IFRS 11, in our view, is not proper.

We agree with the derecognition requirements. However, derecognition shall apply only on loss of significant influence or joint control. Till the time the investor or joint venturer retains significant influence or joint control, any change in ownership interest shall be recognised as a transaction with owners in their capacity as owners.

We would also like to highlight that the derecognition requirement is inconsistent with the proposal to account for additional purchases as an accumulation of purchase. The illustrative example requires the depreciation adjustment to be calculated separately for each purchase. With the existing derecognition requirements, there will be confusion on how to maintain the depreciation adjustment for each purchase.

Our recommendation is not to account for further purchase as an accumulation of purchases but to account as a transaction with owners in their capacity as owners. The investor or joint venturer will remeasure the investment at the changed ownership interest plus or minus the carrying amount of the fair value adjustments. Any difference shall be recognised in retained earnings.

It is not clear how to deal with share in the components of equity of the associate or joint venture on loss of significant influence or joint control such as share-based payment reserves, equity component of compound financial instrument issued by the associate or joint venture and items of other comprehensive income that cannot be reclassified to profit or loss accumulated in separate components of equity. It is not clear whether the share in the components of equity of the associate or joint venture are derecognised or are transferred to retained earnings of the investor or joint venturer. The board may clarify the same. In our view, the share in the components of equity of the associate or joint venture including the components of other comprehensive income that cannot be reclassified to profit or loss must be transferred to retained earnings on loss of significant influence or joint venture.

In the illustrative example given in exposure draft:

Profit of Entity B for the year ended 31 December 20X2 = CU3000

Share in Profit or Entity B for the year ended 31 December 20X2 = CU3000 x 25% = CU750

Effects of initial Fair value adjustments after deferred tax effects = CU150

Share of Entity A in profit or loss of Entity B for the period ended 31 December 20X2 = CU750 – CU150 = CU600

Carrying amount of investment in associate Entity B on 31 December 20X2 = CU7500 + CU600 = CU8100

Consideration paid for further acquisition of 15% in Entity B on 1 January 20X3 = CU5600

Carrying amount of net assets of Entity B on 1 January 20X3 = CU23000

Share in the Carrying Amount of net assets of Entity B on 1 January 20X3 = CU23000 x 40% = CU9200

Carrying amount of Fair value adjustments on initial measurement = CU9000 x 25% x 60% = CU1350

Measurement of Investment in Associate Entity B on 1 January 2023 = CU9200 + CU1350 + CU1000 = CU11550

Loss to be recognised in Retained Earnings on acquisition of further 15% on 1 January 20X3 as per our comments above:

Measurement of Investment in associate Entity B	11550
Less: Cash consideration paid for further acquisition of 15%	5600
Less: Carrying amount of investment in associate Entity B on 1 January 20X3	8100
Loss to be recognised in retained earnings	2150

Question:

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.

Comments:

We do not agree with the proposal that the investor discontinues recognising its share of losses if the carrying amount of the investment in associate or joint venture is reduced to NIL and the investor or joint venturer has not incurred legal or constructive obligation or made payments on behalf of the associate.

The proposals are not consistent with IFRS 10 where the losses are recognised in full despite non-controlling interests becoming negative. Not recognising losses fully does not provide sufficient information on the financial performance of the investor in associate or joint venturer in joint venture to users of financial statements. Such an accounting creates off-balance sheet items and thus hides information from the users of the financial statements. Disclosure of losses not recognised cannot be regarded as presenting fairly the financial performance of the associate or joint venture. Further, such a treatment is inconsistent with the conclusion that non-controlling interests are part of the equity of the group. The interest in associate is a non-controlling interest. If non-controlling interests can be negative under IFRS 10, the same should be the case under equity method. Not recognising loss inflates the profit for the period and earnings per share therby inflating market price per share. Such an accounting does not meet the objective of financial statements stated in IAS 1.

If losses are recognised in excess of the interest in the associate or joint venture, there will be an increase in expense. Any increase in expense is attributed to increase in liability or decrease in asset. In this case, the asset is already reduced to NIL. Therefore, the increase in expense would be attributed to increase in liability. Where the investor or joint venturer has not incurred legal or constructive obligation or made payment on behalf of the associate, the investor or joint venturer has a share in losses which it is not obliged to compensate. Thus, because of the share in losses of the associate or joint venture in excess of the interest in the associate or joint venture, the financial performance of the investor or joint venturer is adversely impacted but not the equity of the investor or joint venturer. Therefore, the share of losses in excess of interest in the associate or joint venture is recognised in a separate component of equity.

As suggested above, the investor or joint venturer entity shall recognise its full share of losses in profit or loss or other comprehensive income despite the interest in the associate or joint venture being reduced to NIL. The investor or joint venturer shall recognise either a liability or a separate component of equity for the excess losses. Where the investor purchases an additional interest in the associate or joint venture, as suggested above, the transaction changes the ownership interests while retaining significant influence and therefore would be accounted as an equity transaction as suggested above. The investor or joint venturer shall transfer the excess losses from the separate component of equity to the investment in associate or joint venture till the separate component of equity is reduced to NIL. This is because the excess losses were because of investment in associate or joint venture. Since the carrying amount of the investment in the associate or joint venture was reduced to NIL, the excess losses could not be adjusted to the investment. Once the investor or joint venturer purchases additional interest in the associate or joint venture, the excess losses remaining to be adjusted shall be adjusted to the extent the carrying amount of the investment in the associate or joint venture is reduced to NIL. The separate component of equity recognised for the excess losses may be transferred to retained earnings on loss of significant influence or joint control in the associate or joint venture

This also puts at rest the issue of associate or joint venture reporting loss in profit or loss and income in other comprehensive income as the investor or joint venturer shall be recognising its full share of losses in profit or loss and income in other comprehensive income or vice versa.

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.

Comments:

As suggested above, any change in ownership interest while retaining significant influence is an equity transaction in line with IFRS 10. Therefore, the disclosure applicable for change in ownership interests without loss of control in subsidiaries shall be made applicable to change in ownership interest in associates while retaining significant influence. The same shall also apply to changes in ownership interest in joint venture.

Question:

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)?

Comments:

Given below are our other comments:

Paragraph Ref. in ED	Comments
13	May be deleted as it only duplicates the recognition, initial measurement and subsequent measurement paragraphs.
14	May be moved as paragraph 2 in Objective. Subsequent paragraphs may be renumbered accordingly.
19	Paragraph 19 of the Exposure Draft states as follows: "*IFRS 9 does not apply to interests in associates and joint ventures that are accounted for using the equity method. When instruments containing potential voting rights in substance currently give access to the returns associated with an ownership interest in an associate or joint venture, the instruments are not subject to IFRS 9. In all other cases, instruments containing potential voting rights in an associate or joint venture are accounted for in accordance with IFRS 9.*" An instrument containing potential voting rights currently giving access to the returns associated with an ownership interest in an associate or joint venture could be classified as either equity or liability in accordance with IAS 32. In this regard, attention is drawn to the requirements of para B86(b) of Ind AS 110, which requires investment in each subsidiary and parent's portion of equity of each subsidiary to be eliminated. This means that if an interest in subsidiary is classified as liability by the subsidiary, the said investment cannot be regarded as 'investment' in subsidiary for the purposes of para 10 of Ind AS 27. Thus, para B86 in a way clarifies instruments that are not classified as equity by subsidiary are within the scope of IFRS 9 and not within the scope of IAS 27. Similarly, IAS 28 could also clarify that instruments that are classified as only equity by the associate in accordance with IAS 32 are within the scope of IAS 28 for consolidated financial statements and IAS 27 for separate financial statements. Therefore, instruments that are classified as financial liability or as compound financial instrument will be measured in accordance with IFRS 9 in separate as well as consolidated financial statements.
26	Paragraph 26 of the Exposure Draft states as follows: "*An investor or joint venturer shall recognise contingent consideration as part of the consideration transferred and measure that contingent consideration at fair value. The investor or joint venturer shall classify:*

	(a) as a financial liability or an equity instrument an obligation to pay contingent consideration that meets the definition of a financial instrument on the basis of the definitions of a financial liability and an equity instrument in paragraph 11 of IAS 32 Financial Instruments: Presentation; and *(b) as an asset a right to the return of previously transferred consideration.*" It is not clear whether commitments to infuse equity in future in an associate or joint venture whether on call of the associate or joint venture or subject to other conditions is to be regarded as contingent consideration. There are commitments by investor in associate or joint venturer in joint venture particularly in case of associates and joint ventures that are created as separate purpose vehicles for service concession arrangements to infuse further equity of substantial amounts in future which are now being disclosed by companies as contingent liabilities. IFRS 9 exempts loan commitments. However, it does not define loan commitments. Therefore, the IASB may clarify – 1. Whether an equity commitment is similar to loan commitment? 2. Are all equity commitments contingent consideration? 3. Whether disclosure of equity commitments as contingent liability is appropriate?