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The Chair
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Dr Wolf Klinz
EFRAG FRB Chair
European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels
Belgium

Ref: EFRAG's due process on the IASB's Exposure Draft Equity Method of Accounting

Dear Dr Klinz,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to respond to the EFRAG's due process with regards to Exposure Draft ED/2024/7 *Equity Method of Accounting*. We are pleased to provide you with the following comments with the aim of improving the consistent application and enforceability of IFRS.

ESMA supports the IASB's efforts to reduce diversity in practice and increase comparability in financial statements by addressing application questions on the equity method of accounting and improving the understandability of IAS 28 *Investments in Associates and Joint Ventures*. ESMA considers that the IASB's proposals will increase the usefulness of information in the entities' financial statements.

In particular, similarly to EFRAG, ESMA supports the proposed definition of cost of the associate or joint venture, positively noting that the proposed definition appears to be in line with the principles of IFRS 3 *Business Combinations*. ESMA also suggests that the IASB clarifies that transaction costs (incremental costs that are directly attributable to the acquisition of additional ownership interest) should be expensed and, hence, should not be included in the carrying amount of the investment.

While ESMA is cognisant that the proposed layered approach to purchasing additional ownership interest in an associate while retaining significant influence could be burdensome in some cases of staged acquisitions, ESMA considers this approach to be superior to other potential solutions that would provide less useful information to users and which could lead to opportunistic accounting and/or would be conceptually problematic.

ESMA generally agrees with the IASB's proposals on the recognition of the investor's share of losses. However, ESMA proposes that the IASB considers limiting the recognition of additional goodwill resulting from changes in the ownership interest when the carrying amount of the investment is nil.

While, like EFRAG, ESMA agrees that the IASB's proposal on the treatment of 'upstream' and 'downstream' transactions with associates would resolve various practical issues, it is concerned about the adverse effect of full recognition of gains and losses on the quality of earnings. ESMA urges the IASB to further explore whether and how these concerns could be addressed by high quality disclosures that provide a high level of transparency regarding the underlying transactions with associates.

ESMA supports the changes to the impairment requirements of IAS 28 proposed by the IASB. In addition, ESMA considers it necessary to include in IAS 28 a requirement for entities to make a formal estimate of the recoverable amount if any of indications in paragraph 57 of the ED are present, similarly to paragraph 8 of IAS 36 *Impairment of Assets*.

ESMA generally supports the proposed disclosure requirements as they would enhance transparency regarding the financial effects of invertors' interests in joint arrangements and associates. ESMA considers, however, that separate disclosure of the reconciliation between the opening and closing carrying amounts of investments accounted for using the equity method should be required for all entities that are individually material and that the changes in ownership interest should be further disaggregated. This reconciliation should also be provided in the separate financial statements.

ESMA's detailed responses are included in the Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit (Isabelle.Grauer-Gaynor@esma.europa.eu).

Yours sincerely,

[Verena Ross]

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Appendix

1 Measurement of cost of an associate

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

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.

1. ESMA supports the proposed definition of the cost of the associate or joint venture. ESMA notes that accounting for obtaining significant influence over an associate or joint control under IAS 28 is generally akin to the accounting for obtaining control of an acquiree under IFRS 3 *Business Combinations* (i.e., 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 is accounted for either as goodwill or as a gain from a bargain purchase). ESMA therefore notes positively the alignment between the proposed definition and the requirements of IFRS 3.

2. The IASB's proposal to measure the cost of obtaining significant influence at the fair value of the consideration transferred, including the fair value of any previously held interest in the associate, would not be excessively costly to implement for entities (including those who currently apply the accumulated cost approach), as, prior to obtaining significant influence, the ownership interest would have already been measured at fair value under IFRS 9 *Financial Instruments*.

3. However, ESMA proposes that the IASB clarifies, similarly to the requirement in paragraph 42 of IFRS 3, how to account for the difference, if any, between the fair value of the previously held ownership interest and its previous carrying amount. This clarification

could be helpful, as the unit of account used to determine the fair value of any previously (i.e. before obtaining significant influence) held ownership interest can have an impact on the determination of the fair value of this ownership interest (e.g. whether a premium for significant influence should be included in the fair value). In this context, ESMA notes that the IASB's Exposure Draft *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value*, which was published in 2014 and aimed to address some questions on the unit of account for investments in associates and joint ventures and on their fair value measurements, has not led to a clarification of the related IFRS requirements.

4. ESMA also supports the proposed treatment of deferred tax effects on initial recognition related to measuring at fair value the investor's share of the associate's identifiable assets and liabilities of the associate which is consistent with the requirements of IFRS 3.

5. ESMA suggests that the recognition of bargain purchase gains should be subject to safeguards similar to those included in paragraph 36 of IFRS 3 and require a reassessment of whether the acquirer has correctly identified all of the assets acquired and all of the liabilities assumed and reviewed the procedures used to measure the corresponding amounts.

6. Moreover, similarly to EFRAG, ESMA considers that the treatment of the transaction costs (incremental costs that are directly attributable to the acquisition of additional ownership interest) should be clarified, as these costs often appear to be significant. However, contrary to EFRAG's recommendation, ESMA is of the view that these costs should be expensed and, hence, not included in the carrying amount of the investment. The treatment of transaction costs should be aligned with IFRS 3, which requires acquisition-related costs to be expensed. ESMA also notes that transaction costs related to the acquisition of the investee's shares before attaining significant influence are expensed if those shares are measured at fair value through profit or loss. Therefore, in this case, the requirement to include transaction costs in the carrying amount of the investment would result in the cost of the associate comprising only a part of the total transaction costs incurred in acquiring the ownership interest (those incurred after obtaining significant influence), which seems inconsistent, even if the unit of account is different before and after obtaining the significant influence.

7. ESMA acknowledges that clarifying whether the equity method is a one-line consolidation or a measurement basis was not the aim of the IASB's Equity Method project and that with the proposed amendments the equity method would remain a hybrid approach with characteristics of both a consolidation approach and a measurement method. However, ESMA considers that the accounting treatment of individual transactions or events (such as obtaining significant influence) should be as inherently consistent as possible. This implies that the requirement to apply consolidation-like accounting on obtaining significant influence should be consistent with the provisions of IFRS 3.

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2 Changes in an investor's ownership interest while retaining significant influence

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

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.

8. While ESMA acknowledges that the proposed layered approach to purchasing an additional ownership interest in an associate while retaining significant influence could be burdensome in some cases of staged acquisitions, it considers this approach to be superior to other potential solutions.

9. ESMA agrees with the IASB that a remeasurement of the previously held interest at fair value when investor purchases an additional interest would be unlikely to provide useful information to users. Moreover, this approach may result in opportunistic accounting and earnings management.

10. ESMA also notes that allowing some form of extrapolation of the fair values of assets and liabilities based on the purchase price allocation (PPA) carried out by the entity on obtaining significant influence (which is proposed by some stakeholders as a simplification) would often be highly subjective and result in some cases in values well away from the actual fair values (especially if there is a significant period of time between obtaining significant influence and acquiring a new interest or if the investee's economic situation changes significantly).

11. As an alternative to the IASB's proposal, some other stakeholders suggest introducing a simplified assumption that the fair value of the consideration transferred is equal to the investor's share of the fair value of the assets and liabilities of the associate or joint venture related to the acquired additional interest (implying that no PPA is required and neither goodwill nor a bargain purchase gain would be recognised on the acquisition of additional shares while retaining significant influence). ESMA is of the view that this approach would be conceptually very difficult to justify. Moreover, it could result in significant differences in the accounting for share acquisitions on obtaining significant influence and thereafter, especially considering that a PPA would be required again (in accordance with IFRS 3) in the case of new acquisitions leading to obtaining control over the investee.

12. With the above considerations in mind, it appears that there is no practical way to avoid a certain degree of complexity. ESMA therefore suggests that the IASB explores whether the situations, in which there are frequent material changes in investor's ownership interest in an associate, leading to a very high degree of complexity combined with significant difficulties in obtaining the necessary data, are very common in practice to determine a proportionate level of complexity and relevance.

13. ESMA supports the IASB's proposals to clarify the accounting for disposals of ownership interest and for other changes in investor's ownership interest in an associate. ESMA notes that some stakeholders suggest allowing entities to derecognise specific layers of investment, when an entity is able to clearly identify which specific portions of its investment it is disposing (e.g. in situations where the shares were acquired by different legal entities within a group). ESMA does not support this suggestion, as it would potentially reduce comparability between entities, create structuring opportunities and would contradict a consolidation view that assumes the group is a single economic entity. Moreover, ESMA considers that there should be conceptual clarity around the identification of the unit of account for the purposes of the disposal of the investment (the investment in the associate is a single unit of account).

14. ESMA supports inclusion of examples of the application of the equity method in the Illustrative Examples to IAS 28. However, ESMA notes that the proposed Example 2 on

the other changes in an investor's ownership interest illustrates only the accounting treatment of an issuance of new equity instruments by an associate to a third party that results in a decrease in the investor's ownership interest. This accounting treatment is much simpler than the treatment of the situation with a buyback of shares by an associate. Therefore, ESMA suggests that the IASB also includes an example of a change in the investor's ownership interest resulting from the associate's redemption of its equity instruments.

3 Recognition of the investor's share of losses

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

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.

15. ESMA generally agrees with the IASB's proposals on the recognition of the investor's share of losses. However, like EFRAG, ESMA proposes that the IASB considers not allowing the recognition of additional goodwill resulting from changes in the ownership interest when the carrying amount of the investment is nil.

16. Moreover, ESMA recommends that, in addition to the example in paragraph 52 which illustrates the accounting in the situation where, after the net investment has been reduced to nil, the investor's share in profit or loss is a loss and its share of the other comprehensive income is a profit, a further example is added covering the following fact pattern:

- the net investment is not reduced to nil,
- the investor's share in total comprehensive income is a loss that exceeds the net investment in the associate, and
- the investor's share in profit or loss is a loss and its share of the other comprehensive income is a profit (or vice versa).

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4 Transactions with associates

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

17. ESMA agrees that the IASB's proposal on the treatment of 'upstream' and 'downstream' transactions with associates would resolve various practical questions, in particular the currently existing conflict between requirements of IAS 28 and IFRS 10 *Consolidated Financial Statements* regarding the recognition of gains or losses from the sale of a subsidiary to its associate. The proposal would also reduce the ongoing application costs for preparers and eliminate some difficulties in accessing information, in particular with regard to 'upstream' transactions.

18. However, ESMA has significant concerns that recognition of gains and losses resulting from all transactions with associates in full could provide some structuring opportunities and potentially have an adverse effect on the quality of earnings (e.g. crossholdings as well as investments in an associate, in which the investor has rights to the majority of the profits yet only significant influence or joint control).Therefore, ESMA urges the IASB to further explore whether and how these concerns could be addressed by high quality disclosures that provide a high level of transparency regarding the underlying transactions with associates. While ESMA recognises that transactions between an entity and its associates are related party transactions within the scope of IAS 24 *Related Party Disclosures*, which already requires certain disclosures about these transactions, ESMA considers that additional information should be disclosed to provide transparency on the rationale for the transactions and how they were priced. This information should help to avoid situations in which transactions reflect a deliberately inflated fair value that does not represent the actual price. If the IASB does not consider it appropriate to require a higher level of transparency than proposed in the ED, ESMA would prefer Alternative 2 described in paragraph BC67 of the ED (i.e. to apply the approach used in IFRS 10 first and then overlay this with the approach used in IAS 28 to restrict the gains or losses recognised to the extent of the unrelated investors' interests in an associate).

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5 Impairment indicators

Question 5 – Impairment indicators (Paragraph 57 of [draft] IAS 28 (revised 202x))
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.

19. ESMA supports the removal of the reference to significant or prolonged decline in fair value and other IASB's proposals regarding the determination of whether there is objective evidence that the net investment in an associate or joint venture might be impaired. ESMA is of the view that the proposed amendments would resolve some application difficulties and improve the consistency of application of the impairment requirements. ESMA does not share concerns expressed by some constituents about potentially increased frequency of impairment testing, as the proposed amendments are generally consistent with the requirements in IAS 36 *Impairment of Assets.*

20. However, ESMA considers it necessary to include in IAS 28 the requirement for entities to make a formal estimate of the recoverable amount if any of indications in paragraph 57 of the ED are present, similarly to paragraph 8 of IAS 36. It is not evident why this requirement should not apply to the net investment in an associate or joint venture.

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

Question 6 – Investments in subsidiaries to which the equity method is applied 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.

21. ESMA generally agrees that the proposals in the ED should also apply to investments in subsidiaries to which the equity method is applied in the investor's separate financial statements. ESMA supports a consistent application of the equity method requirements in both consolidated and separate financial statements. However, ESMA refers to its concerns set out in paragraph 16 of this letter regarding the full recognition of gains and losses resulting from all 'upstream' and 'downstream' transactions and notes that these concerns are even stronger with regard to subsidiaries that, unlike associates and joint ventures, are controlled by the parent entity.

22. In this vein, ESMA is of the view that the reconciliation between the opening and closing carrying amount of investments accounted for using the equity method required in the proposed new paragraph 23B of IFRS 12 *Disclosure of Interests in Other Entities* for the consolidated financial statements should also be provided in the separate financial statements as this information would also be useful for users of those financial statements (especially taking into account that the equity method can be applied in the separate financial statements to a larger group of investments than in the consolidated financial statements). The same applies to the proposed disclosures for contingent consideration arrangements in the proposed new paragraph 91A of IFRS 12. ESMA is not convinced by the opposing arguments that (i) IFRS 12 generally does not apply to separate financial statements and (ii) the disclosure requirements in IAS 27 or other IFRS Accounting Standards do not require the disclosure of quantitative information in separate financial statements about investments in subsidiaries to which the equity method is applied.

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7 Disclosure requirements

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.

23. ESMA generally supports the proposed disclosure requirements, as they would increase the transparency regarding the financial effects of investors' interests in joint arrangements and associates. However, despite the existence of general aggregation and disaggregation requirements in IFRS 18 *Presentation and Disclosure in Financial Statements*, ESMA considers that the disclosure of the reconciliation between the opening and closing carrying amount of investments accounted for using the equity method required by the ED should be required separately for all associates / joint ventures that are individually material. Moreover, changes in ownership interest should be disaggregated in acquisitions, disposals and other changes in ownership interest. Entities should also disclose new recognised goodwill amounts or amounts of the bargain purchase gain (which, based on our understanding can also result from transactions of associates with third parties, e.g. from buying back own shares).

24. In addition, ESMA refers to its proposals for additional disclosure requirements in paragraphs 18 (response to Question 4) and 28 (response to Question 6) above.

8 Disclosure requirements for eligible subsidiaries

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

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

a) to disclose information about contingent consideration arrangements; and

b) 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).

25. ESMA has no comments on this question.

9 Transition

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

The IASB is proposing to require an entity:

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

b) 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

c) 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.

26. ESMA agrees with the IASB's proposals. As the requirement to recognise the full gain or loss on all transactions with associates or joint ventures should be applied retrospectively, ESMA considers that it would be useful if the IASB specifically clarified that the proposals regarding unrecognised share of losses (see Question 3) should be applied prospectively.

10 Expected effects of the proposals

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?

27. ESMA has no comments on this question.

11 Other comments

Question 10 – 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)?

28. Paragraphs 18 and 19 of IAS 28 allow for (a portion of) an investment in an associate or a joint venture to be measured at fair value if certain conditions are met. These paragraphs refer to venture capital organisations, mutual funds, unit trusts and 'similar entities'. ESMA would find it helpful if the IASB provided further explanations on what factors should be considered in this context to determine whether an entity is similar to the above-mentioned entities. Moreover, it could be useful to clarify whether an organisationally separate part of a legal entity could be considered as a 'similar entity'.