Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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20 January 2025

Dr Andreas Barckow
International Accounting Standards Board
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Dear Andreas,

IASB Exposure Draft
Equity Method of Accounting
IAS 28 Investments in Associates and Joint Ventures (revised 202x)

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing, ethics and sustainability disclosures for professional accountants in Hong Kong. We are grateful for the opportunity to provide you with our comments on this Exposure Draft (ED).

We appreciate the IASB's endeavours in formulating proposals that aim to address long-standing application questions in IAS 28, thereby reducing diversity in practice and enhancing comparability and understandability of financial statements. Nevertheless, since the ED does not seek to resolve the fundamental issue of the nature of equity method – whether it is a one-line consolidation or a measurement model – certain application issues would arise. Furthermore, we have identified certain aspects of the ED that necessitate clarification and guidance. We provide detailed comments in the Appendix and summarise our primary concerns and recommendations below.

<u>Accounting for initial and additional purchases and other changes in ownership interests in an associate[1] while retaining significant influence</u>

In respect of the accounting for the initial and subsequent purchases of additional interests of an associate while retaining significant influence, we agree with the proposals for adopting an approach similar to IFRS 3 *Business Combinations*. However, we have identified the following application issues.

a. Treatment of transaction costs

We consider that the ED lacks clarity regarding how transaction costs incurred in the purchase of an associate should be accounted for. Our respondents have expressed mixed views on this treatment. One view supports expensing transaction costs to profit or loss, considering that the ED is developed based on an approach similar to IFRS 3 for measuring the cost of an associate. Conversely, the other view supports capitalising

[1] For simplicity, references in this letter to 'investor', 'associate' and 'significant influence' should be read as also referring to 'joint venturer', 'joint venture' and 'joint control' in relation to investments in joint ventures.

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transaction costs as part of the cost of an associate. This approach is supported by the IFRS Interpretation Committee's agenda decision made in July 2009 and paragraph 6.5 of the *Conceptual Framework for Financial Reporting* (Conceptual Framework), which treats the purchase of an associate as a purchase of an asset, indicating that the costs incurred for acquiring an associate should be capitalised. Given the prevalence of this issue in Hong Kong and the existence of divergent views, we recommend that the IASB explicitly clarify the treatment of transaction costs in the final standard to avoid potential diversity in practice.

b. Cost burden and practical challenges in performing PPA

Our respondents, particularly preparers, have expressed significant concerns regarding the cost burden and practical challenges of performing Purchase Price Allocation (PPA) for each purchase of additional interest in an associate, as well as for other changes that result in an increase in ownership interests. There has long been a practical issue for investors to obtain information from associates due to a lack of control over these entities. Associates are often reluctant to share information beyond what is required for applying the equity method in the investor's financial statements. These challenges are further compounded when measuring the fair value of contingent consideration related to purchases of unlisted associates as determining fair value requires additional information for estimating the associates' future performance. The costs and burden could be more significant for preparers lacking valuation resources. Given these concerns, we recommend that the IASB provide guidance to clarify that PPA is necessary only when its impact on the investor's financial statements is material and explain how such a materiality assessment should be performed.

c. Recognition of a bargain purchase gain

We, along with most of our stakeholders, support recognising bargain purchase gains in profit or loss when purchasing additional interests in an associate that includes previously recognised goodwill. We consider that this treatment aligns with the 'accumulation of purchases' approach adopted throughout the ED. Nevertheless, several respondents consider that such bargain purchase gains should instead be offset against the previously recognised goodwill for practical reasons. These include the potential impact on current practices adopted by investors that are dual-listed on the stock exchanges of Hong Kong and Mainland China and the risk of overstatement of goodwill included in the investment if impairment assessments are not conducted properly. To address these concerns, we recommend the IASB:

(i) provide guidance similar to IFRS 3.36 as a safeguard to address the possibility that a bargain purchase gain is recognised due to an inappropriate PPA;
(ii) state explicitly in the final standard that investments in associates should be tested for impairment as a single unit of account whenever a bargain purchase gain arises; and
(iii) assess the impact of the proposal to jurisdictions where the majority of companies are currently applying the alternative view, and determine if any refinements to the proposal are necessary.

d. Deferred tax effects on purchase of an associate

The current proposals require an investor to perform PPA and recognise the related deferred tax effects when accounting for purchase of an associate, without distinguishing between whether an associate constitutes a business. As per IFRS 3.2(b) and paragraph 15(b) of IAS 12 *Income Taxes*, deferred tax is not recognised upon initial recognition of an asset or a group of assets which does not constitute a business. If the same concept applies to the purchase of an associate, it is unclear why deferred tax should be recognised for the purchase of an associate that does not constitute a business. Accordingly, we recommend that the IASB clarify whether PPA should be performed and consequently, whether the recognition of deferred tax effects should be required for purchases of all associates, including those that only hold assets and do not constitute businesses.

If you have any questions regarding the matters raised in this letter, please contact Carrie Lau (carrie@hkicpa.org.hk) or Katherine Leung (katherineleung@hkicpa.org.hk), Associate Directors of the Standard Setting Department.

Sincerely,

Cecilia Kwei

Cecilia Kwei
Director of Standard Setting

Work undertaken by the HKICPA in forming its views:

The HKICPA:
(a) issued an Invitation to Comment on the ED on 20 September 2024 to its members and other stakeholders;
(b) sought input from its Business Combinations and Reporting Entity Advisory Panel, Small and Medium Practices Committee and its Technical Issues Support Group, which mainly comprise technical and industry experts from large as well as small and medium accounting firms (collectively, Practitioners);
(c) held a public roundtable discussion for local stakeholders, including Practitioners, preparers of listed entities and academics on 19 November 2024;
(d) conducted a targeted outreach to a preparer of a listed corporate;
(e) reviewed the findings from regulators' reports focusing on the review findings related to application of the equity method; and
(f) developed its views through its Financial Reporting Standards Committee, having reflected on its respondents' views. The Committee comprises preparer representatives from various industry sectors, regulators, as well as technical and industry experts from small, medium and large accounting firms.

Detailed comments on the IASB ED

Question 1: Measurement of cost of an associate

1. We appreciate the expected benefits brought by the ED in providing clearer guidance in IAS 28 to address long-standing application issues. We consider it appropriate to apply an approach similar to IFRS 3 for accounting for the purchase of an associate. However, given that the ED does not seek to resolve the fundamental issue of the nature of equity method in terms of whether it represents a one-line consolidation or a measurement model, the following application issues would arise.

(a) Transaction costs

2. The ED is unclear regarding how transaction costs incurred in the purchase of associates should be accounted for. Our respondents have expressed mixed views on the accounting treatment.

   View 1 – Expense transaction costs to profit or loss
   Given that the proposal for measuring the cost of an associate is developed based on an approach similar to the requirements in IFRS 3, this view supports expensing transaction costs to profit or loss to ensure consistency with the treatment of transaction costs under IFRS 3. In addition, since the definition of 'cost of the associate or joint venture' proposed in Appendix A to the ED does not include transaction costs, it could be interpreted that an investor should exclude these costs from the cost of an associate.

   View 2 – Capitalise transaction costs as part of the cost of an associate
   This view considers it more appropriate to capitalise transaction costs as part of the cost of an associate, aligning with an established practice following the IFRS Interpretation Committee (IFRC IC) July 2009 agenda decision (AD) and the principle in paragraph 6.5 of the *Conceptual Framework*. According to the AD, IFRS IC concluded that the cost of an associate includes transaction costs, and the *Conceptual Framework* specifies that historical cost comprises the consideration paid to acquire the asset plus transaction costs. This view is based on the notion that the purchase of an associate is treated as a purchase of an asset.

3. This issue is widespread in Hong Kong, where transaction costs are incurred in almost every purchase of an associate. Given the prevalence of this matter and the varying views on the accounting treatment, diversity in practice is likely to persist without any clarification or guidance. Accordingly, we recommend that the IASB:
   (i) clarify the treatment of transaction costs on initial and subsequent purchases of an associate while retaining significant influence, and explain its rationale in the basis for conclusions, regardless of the view adopted; and
   (ii) explicitly state in the final standard that the treatment of transaction costs applies only to the purchase of an associate in the context of IAS 28, thereby avoiding any unintended consequences in accounting for transaction costs related to the purchase of other assets.

(b) Contingent consideration and measurement period adjustments

4. BC 91 of the ED states that the IASB decided that the proposed requirements on contingent consideration should be similar to those in IFRS 3 for the acquisition of a subsidiary. Based on this premise, we have the following comments and recommendations for the IASB's consideration.

5. Firstly, we believe that the proposed requirements for contingent consideration in IAS 28, both in terms of wording and requirements, should align as closely as possible with the requirements in IFRS 3.58, where applicable. Specifically, paragraph 26 of the ED should include:
   (i) references to IFRS 9 *Financial Instruments;* and
   (ii) the requirements on measurement period adjustments for both initial purchase of an associate and subsequent additional purchases while retaining significant influence.

6. We consider that the requirements for measurement period adjustments under IFRS 3.45 to 49 and 58 are relevant to the purchase of associates. Similar to business combinations, an investor of an associate may encounter situations where provisional amounts need to be reported if the measurements of the associate are incomplete at the end of the reporting period. Measurement period requirements provide guidance on determining the measurement period and how the investor identifies and accounts for measurement period adjustments. The impact of measurement period adjustments could be significant depending on facts and circumstances.

7. Secondly, it is not clear whether subsequent changes in contingent consideration associated with the purchase of an associate should be presented in the investor's statement of profit or loss, viz. operating or investing category. Due to the lack of specific guidance in the ED and IFRS 18, it appears reasonable to follow IFRS 18.B49(f) and B55(c) on remeasurement of contingent consideration arising from a business combination given that the proposal for contingent consideration aligns with the approach in IFRS 3. Consequently, the remeasurement of contingent consideration from purchase of an associate would be categorised under the 'operating' category. However, this would be inconsistent with presenting income and expenses from investments in associates under the 'investing' category per IFRS 18.53 and 55.

8. Given the above, we recommend that the IASB clarify whether the above presentation outcomes align with the intended objectives of IFRS 18. If not, appropriate amendments to IFRS 18 should be considered to ensure consistent categorisation of such items in the investor's statement of profit or loss.

(c) Deferred tax effects on purchase of an associate

9. The ED requires investors to perform a PPA and recognise the related deferred tax effects in accounting for the purchase of an associate, without distinguishing between whether the associate constitutes a business. However, IFRS 3 does not apply to the acquisition of an asset or a group of assets that does not constitute a business (IFRS 3.2(b)). In such cases, the investor should allocate the purchase price to the assets acquired and liabilities assumed based on their relative fair values and no deferred tax should be recognised (IAS 12.15(b)). If the same concept applies to the purchase of an associate, it is unclear why (i) a PPA should be performed, and (ii) deferred tax should be recognised in the case of an associate that does not constitute a business.

10. In light of the above, we recommend that the IASB clarify whether PPA should be performed and consequently, whether the recognition of deferred tax effects should be required for **all** purchases of associates, including those that do not constitute a business.

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

(1) <u>Purchase of additional interests in an associate</u>

(a) Cost burden and practical challenges in performing PPA for each purchase of additional interest

11. While acknowledging the IASB's rationale for performing PPA for each purchase of additional interest in an associate, our respondents, particularly preparers, have expressed significant concerns regarding the costs and practical challenges of implementing the proposed requirements:
    (i) Based on past experience and market practice, investors often encounter difficulties in obtaining the necessary information from their associates to conduct PPA. To protect sensitive commercial information and maintain fairness between all shareholders, listed associates are often reluctant to share information beyond what is required for applying the equity method in the investor's financial statements.
    (ii) Measuring the fair value of contingent consideration can be complex in the case of purchases of unlisted associates. Determining the fair value in such instances often requires the use of discounted cash flow methods, which rely on estimates of the associates' future performance. This process demands significant judgement and estimation assumptions.
    (iii) The above issues are further exacerbated when fair value measurements are required for each purchase of additional interest of an associate, increasing costs and burdening preparers who lack sufficient valuation resources.

12. To alleviate these concerns, we recommend that the IASB provide guidance to:
    (i) clarify that PPA is necessary only when its impact on the investor's financial statements is assessed to be material; and
    (ii) explain how such a materiality assessment should be performed, including the factors for consideration and methodologies that can be used for conducting the assessment.

(b) Recognition of a bargain purchase gain

13. We, along with most of our respondents, support the ED's proposal for the recognition of bargain purchase gains in profit or loss arising from purchase of additional interests when the investment in the associate includes previously recognised goodwill for the following reasons:
    (i) We agree with the IASB's rationale explained in BC26-27 of the ED. We consider it logical to recognise bargain purchase gains from the purchases of additional interests separately in profit or loss as the ED adopts an 'accumulation of purchases' approach to measure the cost of an associate. This approach also applies to other proposals in the ED, such as the proposal for not catching up the unrecognised losses in subsequent purchases. Therefore, deviating from this approach could lead to potential unintended consequences for other proposals.
    (ii) We agree that a bargain purchase gain could be an indication of impairment, necessitating an impairment assessment based on IAS 36 *Impairment of Assets*. We believe that a proper impairment assessment can prevent the potential issue of overstating goodwill included in the carrying amount of the investment. Conversely, applying an offset approach, as indicated below, might inadvertently create an impression that impairment is unnecessary as the goodwill embedded in the carrying amount of the associate has been reduced after offsetting, thereby increasing the risk of overstatement of investments in associates.

14. Nevertheless, several respondents do not support the proposal. They argue that bargain purchase gains should be offset against previously recognised goodwill embedded in the carrying amount of the associate for the following practical reasons:
    (i) In practice, investors, particularly those that are dual-listed on the stock exchanges of Hong Kong and Mainland China, currently offset bargain purchase gains against previously recognised goodwill because this treatment is specified in the China Accounting Standards for Business Enterprises. This treatment is based on the premise that cumulative purchases of interests in an associate are regarded as a single asset for subsequent impairment tests and disposals. The proposal would alter the accounting practice for these investors.
    (ii) A bargain purchase gain may indicate that an impairment exists. Recognising such a gain in profit or loss might result in an overstatement of the investment in the associate if the investor fails to conduct a proper impairment assessment of the investment which includes goodwill.
    (iii) Recognising bargain purchase gains in profit or loss for additional purchases while retaining significant influence is inconsistent with the treatment of purchasing additional interests in a subsidiary after gaining control in IFRS 10 *Consolidated Financial Statements*. Under IFRS 10, the impact does not affect profit or loss but is reflected within equity as transactions with non-controlling interests.

15. We acknowledge the concerns of the alternative view regarding the risk of potential overstatement of goodwill due to inappropriate impairment assessments and the potential impact on the companies that are dual-listed on the stock exchanges of Hong Kong and Mainland China. To address these concerns, we recommend that the IASB:
    (i) provide guidance requiring investors to perform procedures similar to those in IFRS 3.36 as a safeguard to ensure that the measurements appropriately reflect consideration of all available information as of the purchase date before recognising a bargain purchase gain. This would help mitigate the possibility of recognising a bargain purchase gain due to an inappropriate PPA;
    (ii) state explicitly in the final standard that investments in associates should be tested for impairment as a single unit of account whenever a bargain purchase

gain arises; and

(iii) assess the impact of the proposal on existing practice, particularly in jurisdictions where entities are currently applying the alternative view, and determine if any refinements to the proposal are necessary.

(2) Other changes in ownership interests in an associate

(a) Cost burden and practical challenges

16. We agree with the proposal requiring an investor that retains significant influence to recognise an increase in its ownership interest as if purchasing an additional ownership interest. However, we are also aware that all the issues related to cost burden and practical challenges in performing PPA, as highlighted in paragraph 11 regarding the accounting for purchase of an additional ownership interest, would also arise if this proposal is implemented. To address these concerns, we recommend that the IASB provide guidance on materiality consideration as suggested in paragraph 12.

(b) Application of paragraphs 34(a) and (b) of ED

17. We consider the calculation of the effect of other changes in ownership interest arising from deemed purchases and deemed disposals to be complex, and the wording in paragraphs 34(a) and (b) of the ED is difficult to understand. This could lead to varied interpretations of the requirements resulting in diversity in practice. We note that IE3 of the ED, which illustrates the application of paragraph 34(b) of the ED to deemed *disposals*, is helpful for clarifying the requirement. Therefore, we recommend that the IASB incorporate an illustrative example for deemed *purchases* resulting from a redemption of shares by the associate to assist preparers in understanding the proposed requirements.

18. We understand that the ED focuses solely on developing requirements for simple scenarios of deemed purchases and deemed disposals due to cost-benefit considerations (BC45-46 of the ED). However, our respondents have emphasised the need for clear guidance to address the following prevalent scenarios in Hong Kong, particularly in the case of listed associates:
    (i) Due to different extents of participation by the investor and other shareholders in share redemption and share issuance by an associate:
        (a) the investor's ownership interest decreases when the associate redeems its shares;
        (b) the investor's ownership interest increases when the associate issues new shares; and
    (ii) Under an equity-settled share-based payment arrangement, the employees of an associate exercise the share options issued by the associate, resulting in a deemed disposal of the investor's ownership interest in the associate.

19. In light of the above, we believe it would be beneficial for many preparers if the IASB could provide guidance and illustrative examples to address these common scenarios. In respect of scenario (i)(b) in paragraph 18, we noted that the September 2022 IASB staff paper discussed a similar example where the investor subscribes for 100% of the new shares issued by the associate. We recommend the IASB include this example or adjust it as appropriate to assist preparers in applying the proposed requirements.

Question 3: Recognition of the investor's share of losses

Recognising and presenting separately the share of the associate's profit or loss and other comprehensive income (OCI)

20. Regarding the proposal for recognising and presenting separately the share of the associate's profit or loss and OCI, we consider that paragraphs 45-52 and IE4 of the ED are unclear and could lead to confusion and application issues. We recommend that the IASB clarify the requirements and provide guidance should it proceed with the proposals. These issues are summarised as follows.

21. Firstly, paragraphs 45 and 48 of the ED specify that, in determining when an investor (i) reduces its net investment in an associate to nil, or (ii) resumes recognising its share of profit, the investor should consider the associate's total comprehensive income. However, paragraph 50 of the ED requires the investor to recognise separately its share of the associate's profit or loss and its share of the associate's OCI. It is unclear how these paragraphs interact with each other, particularly whether the investor's share of unrecognised losses should be considered separately for profit or loss and OCI respectively, or in aggregate at the level of total comprehensive income, without differentiating between the amounts arising from profit or loss and OCI.

22. Secondly, the examples in paragraph 52 and IE4 of the ED illustrate that when an investor has unrecognised losses in an associate, the investor is required to recognise the same absolute amount of its share of the associate's OCI (if it is a profit) and share of profit or loss (if it is a loss) simultaneously in accordance with paragraph 50 of the ED, while continuing to measure its investment in the associate at nil. We have the following concerns regarding these examples:
    (i) Contrary to the accounting outcome in paragraph 50 of the ED, when applying paragraph 48 of the ED to these examples, we consider that the investor should not recognise any share of profit in OCI because the total comprehensive income is a loss. This indicates inconsistencies between paragraphs 48 and 50 of the ED.
    (ii) The statement of profit or loss is the primary source of information about an entity's financial performance and the main focus for financial statement users to assess the financial performance of the entity. The treatment of recognising a profit in the statement of profit or loss while the carrying amount of the investment in an associate is nil and there are cumulative share of associate's unrecognised losses could be confusing and misleading to financial statement users. Some respondents recommend that the IASB consider requiring the investor to recognise any share of associate's profit or loss or OCI only when the respective unrecognised losses are eliminated.

23. Thirdly, paragraph 51 of the ED requires an investor to recognise its share of the associate's profit or loss first and then its share of OCI until the net investment in the associate is reduced to nil, if both profit or loss and OCI are losses. However, questions arise regarding:
    (i) the accounting treatment for other scenarios, such as a loss in the share of the associate's profit or loss and a profit of the share of OCI, or vice versa, in which cases the share of the total comprehensive income is a loss that exceeds the investment in an associate; and
    (ii) whether the order for recognising profits in profit or loss and in OCI when an investor resumes recognising its share of the associate's profits is the same as the order in paragraph 51 of the ED.

24. Lastly, a question arises on the accounting treatment in situations where the carrying amount of the net investment in an associate is reduced to nil due to an impairment loss and a share of the associate's losses remains unrecognised. If there is a subsequent reversal of the impairment loss on the investment in that associate, it is unclear whether the investor should offset this reversal against the cumulative share of the associate's unrecognised losses. We note that this situation occurs in some listed biotechnology companies, which incur losses due to heavy investments in research and development in their early phases and the need for and extent of recognising any impairment loss is influenced to a large extent by fluctuating market capitalisation.

Question 4: Transactions with associates

25. We support the proposal for investors to recognise full gains or losses from all transactions with their associates because according to both the *Conceptual Framework* and other IFRS Accounting Standards, associates are not part of the group and are not in the boundary of the reporting entity. In addition, the proposed method is simpler and less costly to apply.

26. However, paragraph 53 of the ED provides only two examples of transactions with associates that would fall within the scope of the proposal, both of which involve a sale of assets. We recommend that the IASB clarify whether the proposal also applies to other types of transactions, such as rendering of services.

Other questions in the ED

27. We support the proposals and do not have any specific comments on Question 2(b) regarding the disposal of an ownership interest in an associate and Questions 5-11 of the ED.

~ End ~