EFRAG

European Financial Reporting Advisory Group

INVITATION TO COMMENT ON THE EFRAG'S ASSESSMENTS OF THE AMENDMENTS TO IFRS 1 AND IAS 27 "COST OF AN INVESTMENT IN A SUBSIDIARY, JOINTLY CONTROLLED ENTITY OR ASSOCIATE"

Comments should be sent to commentletter@efrag.org or uploaded via our website by 1 July 2008

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the amendments to IFRS 1 *First-time Adoption of International Reporting Standards* and IAS 27 *Consolidated and Separate Financial Statements* "Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate" (the Amendments). In order to do that, EFRAG has been carrying out a technical assessment of the Amendments against the criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the EU.

A summary of the Amendments is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record unless the respondent requests confidentiality. In the interests of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:
_**Comissão de Normalização Contabilística (CNC)** ___

(b) Are you/Is your organisation or company a:

□ Preparer □ User **x** Other (please specify)_**The Portuguese Accounting Standards Setter** ____________

(c) Please provide a short description of your activity/ the general activity of your organisation____
We issue accounting standards and guidelines______

(d) Country where you/your organisation or company is located:
Portugal____
_____

(e) Contact details including e-mail address:
cecnc@igf.min-financas.pt____

2 EFRAG's initial assessment of the Amendments is that they meet the technical criteria for endorsement. In other words, they are not contrary to the true and fair principle and they meet the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

Yes **X** No

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If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

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(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the Amendments? If there are, what are those issues and why do you believe they are relevant to the evaluation?

_**No**____

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3 EFRAG is also assessing the costs that will arise for preparers and for users to implement the Amendments both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the work. The results of the initial assessment are that the Amendments will not involve users or preparers incurring significant year one cost or ongoing costs. EFRAG's reasoning is set out in Appendix 3.

Do you agree with this assessment?

Yes **X** No

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If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

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4 As EFRAG believes (as explained in Appendix 3) that the Amendments will improve the quality of the financial information provided and its implementation will only involve insignificant costs, it has tentatively concluded that the benefits to be derived from applying the amendments will exceed the costs involved.

Do you agree with this assessment?

Yes **X** No

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If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

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5 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the Amendments.

Do you agree that there are no other factors?

Yes **X** No

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If you do not, please explain why you do not and what you think the implications should be for EFRAG's endorsement advice?

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APPENDIX 1
A SUMMARY OF THE AMENDMENTS TO IFRS 1 AND IAS 27

Deemed cost

1 When an entity prepares its first IFRS financial statements, unless IFRS 1 contains an exemption from applying a requirement in an other IFRS, the entity shall, in its opening IFRS balance sheet, apply those other IFRSs in full when recognising and measuring assets and liabilities.

2 IAS 27 requires that an entity with an investment in a subsidiary shall measure that investment in its separate financial statements at either cost or fair value. Similar requirements apply in the case of investments in jointly controlled entities and investments in associates. Under existing IFRS 1 there is no exemption from this requirement.

3 Measuring such investments at cost on transitioning to IFRS is difficult for those entities that have been required or permitted by local GAAP to account for such investments at an amount other than cost.

4 The Amendments change IFRS 1 so that a first-time adopter is permitted, in its separate financial statements, to use as deemed cost of an investment in a subsidiary, jointly-controlled entity or associate either fair value (determined in accordance with IAS 39) at the entity's date of transition to IFRSs or the previous GAAP carrying amount at that date. Thus, an entity can either choose to apply IAS 27—and as a result measure such investments at cost or fair value—or choose to apply the new exemption at its date for transition to IFRSs—and therefore measure such investments at either the transition date fair value or the transition date local GAAP carrying amount.

Deletion of the cost method in IAS 27

5 Currently, IAS 27 requires application of the so-called cost method in accounting for dividends received from investments in subsidiaries, jointly-controlled entities and associates. This means that, when the investor receives a dividend from such an investment, it needs to determine whether the dividend is paid out of the accumulated profits of the investee that have arisen since the date of acquisition (ie 'post-acquisition profits') or pre-acquisition profits. Dividends paid out of post-acquisition profits are accounted for as income, and dividends paid out of pre-acquisition profits are treated as a reduction in the cost of the investment.

6 Accounting for such dividends in this way is difficult for those entities that have been required or permitted by local GAAP to account for such dividends differently.

7 The Amendments delete the cost method from IAS 27. This means that the investor is no longer required, when preparing its separate financial statements, to determine whether a dividend received from an investment in a subsidiary, jointly-controlled entity or associate is paid out of post- or pre-acquisition profits. Instead, the Amendments require the investor to recognise such a dividend as income in profit and loss.

8 In accordance with existing IAS 36 *Impairment of Assets,* the investor is required to assess at each reporting date whether there is any indication that the

investments may be impaired. (If such an indication exists, the entity is required to carry out an IAS 36 impairment test).

9 The Amendments amend IAS 36 to make clear some circumstances in which the receipt of a dividend from an investment in a subsidiary, jointly controlled entity or associate might indicate that that investment is impaired.

Measurement of cost in the separate financial statements of a new parent

10 The Amendments also clarify how to determine the cost of an investment in accordance with IAS 27 when a parent reorganises the operating structure of its group by establishing a new entity as its parent and this new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent. The result is that the assets and liabilities of the new group and the existing group are the same immediately before and after the reorganisation, as are the absolute and relative interests of the owners of the original parent in the net assets of those groups. In such circumstances the Amendments clarify that the cost of the investment in the original parent shall be measured at the carrying amount of the new parent's share of the equity items shown in the original parent's separate financial statements at the date of reorganisation.

Effective date and transition

11 Entities are required to apply the Amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted.

12 The amendments to IFRS 1 and the amendments to delete the cost method in IAS 27 are to be applied prospectively. The amendment regarding reorganisations described in paragraph 10 above must be applied to all reorganisations occurring in annual periods beginning on or after 1 January 2009. Entities are also permitted to apply it retrospectively to past reorganisations. However if an entity applies it to past reorganisations, it shall restate all later reorganisations within the scope of that amendment.

APPENDIX 2
EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENDTS AGAINST THE ENDORSEMENT CRITERIA

In its comment letter to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do no necessarily indicate that conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

1 When evaluating the merits of the Amendments, EFRAG considered the following key questions:

   (a) Are the Amendments consistent with the IASB's Framework for the Preparation and Presentation of Financial Statements *(the Framework)*?

   (b) Would the Amendments' implementation result in an improvement in accounting?

   (c) Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?

2 The amendments to IAS 18 *Revenue* and IAS 21 *The Effects of Changes in Foreign Exchange Rates* are a consequence of the amendments to IAS 27 and in EFRAG's view do not require separate evaluation.

3 The amendment to IAS 36 *Impairment of Assets* does not change the present requirements of the standard; it merely provides additional guidance as to indicators of possible impairment. This means in EFRAG's view that the amendments to IAS 36 do not require a separate evaluation as the present requirements are already endorsed for use in the EU.

Are the Amendments consistent with the Framework?

4 In EFRAG's view, the aspects of the Framework that are most relevant for this purpose are the qualitative characteristics of relevance, reliability, comparability and understandability and the material dealing with recognition of income and measurement of the elements of financial statements.

   (a) The Amendments will be judged against the qualitative characteristics later in this appendix, so this section does not focus on that aspect of the Framework.

   (b) Paragraph 100 of the Framework describes a number of different measurement bases that are "employed to different degrees and in varying combinations in financial statements". It also defines what the Framework

means by historical cost (the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire [the asset] at the time of [its] acquisition"). The material in the Framework on measurement is nevertheless different from the material in other parts of the Framework in that it is not as definitive; it describes in fairly general terms the sort of things that entities are currently doing but does not describe how they should be measured. As such, EFRAG believes that the question of whether a measurement basis required by the amendment is consistent with the Framework does not arise.

Therefore, in this section EFRAG has focused on what the Framework says about income.

5 According to paragraph 92 of the Framework, income is recognised in the income statement when an increase in the future economic benefit related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably.

6 Under the amendments, when the investor has a right to receive a dividend from its investment in a subsidiary, jointly controlled entity or associate, income has arisen and should be recognised. EFRAG agrees that the right to receive the dividend will result in an increase in the entity's receivables and can be measured reliably. In EFRAG's view this accounting of dividend is consistent with the definition and recognition criteria for income set out in the Framework.

Would the Amendments' implementation result in an improvement in accounting?

7 It is clear from the discussions that EFRAG has had during its meetings and from the comment letters it has received that it can be difficult for an entity applying IFRS for the first time in its separate financial statements to comply with the present requirements of IAS 27 relating to:

- the cost of an investment in a subsidiary, jointly controlled entity or associate; and
- the treatment of dividends received from such investments,

particularly if, under previous GAAP, the carrying amount of the investments has been measured in a manner that is not in accordance with the present IAS 27.

8 In EFRAG's view, the Amendments provide relief from those difficulties.

9 EFRAG understands that the difficulties described above are preventing some 'investor entities' adopting IFRSs in their separate financial statements. It follows that, by providing relief from the difficulties, the Amendments will make it easier for 'investor entities' to adopt IFRSs in their separate financial statements—and will make it more likely that such entities will adopt IFRS. EFRAG believes that this will result in a general improvement in the quality of financial reporting.

10 EFRAG has also considered what the impact of the Amendments is likely to be on the quality of the information provided.

Comparability

Deemed cost

11 The amendment that allows entities transitioning to IFRS to use in their separate financial statements transition date fair value or transition date previous GAAP carrying amounts as the deemed cost of their investments in subsidiaries, jointly-controlled entities and associates will mean that such investments could be measured in one of four different ways (at cost or remeasured at fair value in accordance with IAS 27 as previously or transition date fair value or transition date previous GAAP carrying amount). This will clearly have an impact on comparability, both among first-time adopters applying this exemption and between future adopters of IFRS and entities already applying IFRSs.

12 On the other hand, this amendment (and the deletion of the cost method, which is discussed below) removes what for some entities is a significant barrier to the adoption of IFRS in the separate financial statement; in other words, it makes it possible for more entities to adopt IFRS. Of course, the more entities applying the same set of standards, the more comparable financial statements are in general.

13 EFRAG has previously recommended endorsement of IFRS 1, which contains a similar exception from IFRS 3 for the restatement of business combinations at the date of transition to IFRSs. This amendment extends that exception to the parent's separate financial statements and to investments in jointly-controlled entities and associates, thereby achieving a degree of consistency.

Deletion of the cost method

14 Deletion of the cost method applies not only to first time adopters but also to all other entities applying IFRSs that have such investments. This means that future return on such investments recognised in profit or loss will be accounted for in the same way by all entities, so there are no comparability issues arising from this amendment.

Measurement of cost in the separate financial statements of a new parent

15 Allowing, in the circumstances described in the Amendments, a new parent to measure the cost of its investment in the original parent in its separate financial statements at the carrying amount of its share of the equity items in the original parent should not reduce the comparability because, in this particular type of reorganisation, the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation.

Understandability

Deemed cost and deletion of the cost method

16 The present IFRS 1 requires first-time adopters to apply IAS 27 retrospectively to the measurement of investments in subsidiaries, jointly controlled entities or associates at the date of transition to IFRSs. That means such investments will be measured at either fair value or cost. Dividends received from pre-acquisition accumulated profits of such investments are to be treated as a reduction in the cost of the investment and dividends received from post-acquisition profits are to be treated as income.

17 Henceforth, investments in subsidiaries, jointly controlled entities or associates could be measured by the investor in its separate financial statements on any one of four bases (as mentioned in paragraph 11 above) and all dividends from such entities are to be treated as income. The notion of paying dividends out of pre- or post-acquisition profits is eliminated; instead the focus is on whether the payment of the dividend might have resulted in an impairment.

18 In EFRAG’s view the information resulting from the Amendments will be understandable by users. Although the introduction of two more measurement bases (transition date fair value and transition date previous GAAP amount) is not ideal for users, it will enable more entities to adopt IFRSs in the separate financial statements which ought in many cases to result in a general improvement in the understandability of their financial statements.

Measurement of cost in the separate financial statements of a new parent

19 EFRAG also believes that the amendment relating to group reorganisations should also not reduce the understandability of the information provided. In effect, nothing of substance has happened, and EFRAG would not expect there to be an accounting effect in such circumstances.

Relevance and reliability

20 The effect of the Amendments is:

(a) to allow other bases to be used in the separate financial statements of an investor when measuring investments in subsidiaries, jointly-controlled entities and associates on transitioning to IFRS;

(b) to recognise all dividends received from investments in subsidiaries, jointly-controlled entities and associates as income without considering whether the dividend is paid out of pre-acquisition or post-acquisition accumulated profits.. Previously dividends paid out of pre-acquisition dividend were treated as a reduction in the cost of the investment; henceforth they will be treated as income, and in some cases this could result in an impairment loss being recognised;

(c) to clarify how certain types of group reorganisation should be accounted for.

21 EFRAG has considered the effect that these changes might have on the relevance of the information provided.

(a) IAS 27 requires investments in subsidiaries, jointly-controlled entities and associates to be measured at cost or fair value. It would appear to follow from this that other measurement bases—in other words, the measurement bases that, as a result of the amendments, are not allowed when transitioning to IFRS—are considered to be less relevant. On the other hand, this amendment (together with the one described in paragraph 20(b) above) makes it possible for more entities to adopt IFRS in the separate financial statements. EFRAG believes that this will result in a general improvement in the relevance of the financial statements involved.

(b) Although the change described in paragraph 20(b) above is a different way of accounting for dividends, EFRAG’s initial assessment is that it will result in an improvement in the relevance of the information provided because it

enables the introduction of the type of impairment accounting approach that is applied generally under the cost accounting model.

(c) In EFRAG's view, the effect described in paragraph 20(c) above has no implications for the relevance of the information provided, because it is simply a clarification of an existing requirement.

22 EFRAG has also considered the effect that the changes described in paragraph 20 might have on the reliability of the information provided.

(a) EFRAG believes that the amendment described in paragraph 20(a) above is likely to have the effect of improving the reliability of the measures used, because it is less likely now that entities wishing to transition to IFRS but not currently measuring their investments in subsidiaries, jointly-controlled entities and associates at cost will need to estimate that cost amount. On the other hand, some of the measurement bases now allowed will not always represent a good proxy for cost, so it could be argued that this might affect the representational faithfulness of the information provided. However, EFRAG disagrees with this argument; the measurement base used is required to be disclosed, so in its view the issue of whether the measurement basis used is a faithful representation of cost does not arise—the measure is a faithful representation of the measure it purports to be.

(b) EFRAG's initial assessment is that the change described in paragraph 20(b) above will not have a significant effect on the reliability of the information provided. It reduces the amount of estimation and judgement involved because it is no longer necessary to differentiate between dividends paid out of pre-acquisition profits and dividends paid out of post-acquisition profits; on the other hand, it makes it a little more likely that some investments will be carried at impaired amounts.

(c) In EFRAG's view, the effect described in paragraph 20(c) above will for many entities have no implications for the reliability of the information they provide, because it will merely confirm their interpretation of existing standards. However, for some entities it could involve a change in accounting and for those companies EFRAG believes it will involve using a measure that is easier to estimate and therefore more reliable.

Conclusion

23 For the above reasons, EFRAG has tentatively concluded that the Amendments are likely to result in an improvement in the information provided.

Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?

24 EFRAG has considered whether it believes that the Amendments meet the requirements of the European Parliament and of the Council on the application of international accounting standards, in other words that the Interpretation:

(a) is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG has also considered whether it is in the European interest to adopt the Amendments.

25 As explained above, EFRAG has concluded that the Amendments are consistent with the Framework and are likely also to result in an improvement in the information provided. In particular, EFRAG has concluded that the Amendments meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

26 EFRAG has also concluded that there was no reason to believe that the information resulting from the application of the Amendments would be contrary to the true and fair view principle.

Conclusion

27 Having considered the various arguments described in this Appendix, EFRAG has concluded that the Amendments satisfy the criteria for endorsement in the EU.

APPENDIX 3
EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENTS

Costs for preparers

1 EFRAG has considered whether applying the accounting treatment required by the Amendments would involve significant incremental implementation (ie year one) or recurring (ie ongoing) costs for preparers.

2 The amendment to allow an entity to use either fair value or the previous GAAP carrying amount as deemed cost when measuring, in its separate financial statements, investments in subsidiaries, jointly controlled entities and associates at its date of transition to IFRSs is intended to reduce the work involved—and therefore the cost—of transitioning to IFRS for those entities that choose to take advantage of the amendment. EFRAG believes that it will do that. Allowing previous GAAP carrying amount as deemed cost in particular will mean that no additional work will have to be done in relation to measurement of such investments at the date of transition to IFRSs.

3 The amendment to delete the "cost method" currently in IAS 27 means that henceforth preparers will not be required, when accounting for dividends received from investments in subsidiaries, jointly-controlled entities and associates, to distinguish between pre- and post acquisition accumulated profit to determine whether the dividend is a return of the investment or not. This will mean less work—and therefore lower costs—for preparers. On the other hand, another amendment extends the list of indicators that an investment in a subsidiary, jointly-controlled entity or associate might be impaired. This amendment will apply to all investors, not just to those transitioning to IFRS. Some might argue that this means that more IAS 36 impairment tests than hitherto might need to be carried out and that this will increase the costs involved to preparers. Preparers are already required in accordance with IAS 36 to assess at each reporting date whether there is any indication of such investments being impaired. On the other hand, as one implication of deleting the cost method is that all dividends from investments in subsidiaries, jointly-controlled entities and associates will be treated as income rather than, in some cases, as a return of the investment, it is possible that there will be an increase in the number of impairments identified, which will result in some additional work. Where this is the case, EFRAG believes it is possible that the amendment will result in incremental cost; however, it also believes that, for the majority of entities affected, the overall effect of this amendment will be a cost saving.

4 The amendment requires, when there has been a group reorganisation of the type described in new paragraphs 38B and 38C of IAS 27, the carrying amount of the equity interest in the original parent that has been exchanged for equity interests in the new parent shall be used as the cost of the new parent. This is intended to be a clarification of the existing requirement. Therefore, in assessing the costs for preparers that arise from this amendment, EFRAG has considered whether the accounting required by this amendment would involve more costs for preparers than any of the other approaches that might have been possible prior to the clarification. EFRAG is not aware of any approach that would have involved a lower cost. Therefore, EFRAG's initial assessment is that this amendment will involve a cost saving for some preparers and no change in cost for other preparers.

5 For the above reasons, EFRAG’s initial assessment is that overall the implementation of the Amendments will involve additional costs only for a small number of companies that will need to carry out more IAS 36 impairment tests because they will no longer treat any part of a dividend received from an investment in a subsidiary, jointly-controlled entity or associate as a reduction in the cost; the vast majority of preparers affected by these Amendments are likely to see a reduction in their costs.

Costs to users

6 Users will incur some incremental year one costs in understanding the effects of the Amendments on the comparability of the information provided by entities transitioning to IFRS from 1 January 2009, if an entity applies a deemed cost as allowed by the amendment to IFRS 1. On the other hand, the Amendments are likely to result in increase in the number of entities applying IFRS in the parent financial statements, which will make it easier for users to analyse the information provided.

7 Similarly, the amendment to recognise all dividends from investments in subsidiaries, jointly-controlled entities and associates as income in the investor’s separate financial statements will involve some year one costs for users in understanding the amendment. However, EFRAG believes that the amendment ought to make the information more understandable, which is likely to result in an decrease in ongoing costs for users.

8 The amendment to clarify how certain types of group reorganisation should be accounted for ought not to involve users in any additional costs because it just clarifies the accounting that should have been adopted prior to the amendment.

9 However, although users may incur some incremental costs, EFRAG’s view is that these costs are likely to be insignificant.

Benefits for preparers and users

10 EFRAG’s assessment is that the Amendments will make it less burdensome for entities to transition to IFRS than hitherto. This will also make it likely that more entities will adopt IFRS, with all the benefits that that will bring.

11 EFRAG has also concluded, for the reasons explained in Appendix 2, that the Amendments will improve the information provided.

Conclusion

12 To summarise, EFRAG’s tentative assessment is that the Amendments will involve only insignificant incremental costs for preparers and users, and in some cases could even result in cost savings. EFRAG’s initial assessment is also that the Amendments are likely to result in benefits for both users and preparers. As a result, EFRAG’s initial assessment is that the benefits of implementing the Amendments will exceed the costs.