EFRAG
European Financial Reporting Advisory Group

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European Commission
Directorate General for the Internal Market
1049 Brussels

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Dear Mr Holmquist

The Amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (henceforth 'the Amendments'). The Amendments were preceded by two exposure drafts, both of which EFRAG commented on.

The Amendments:

- allow a first-time adopter in its separate financial statements to use as the deemed cost of an investment in a subsidiary, jointly controlled entity or associate either the fair value at the entity's date of transition to IFRSs or the previous GAAP carrying amount of the investment at that date;

- delete from IAS 27 the definition of the 'cost method', with the result that an investor is required to recognise as income in its separate financial statements all dividends received from a subsidiary, jointly controlled entity or associate, even if the dividend is paid out of pre-acquisition reserves.

- clarify how to determine the cost of an investment under 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 Amendments become effective for annual periods beginning on or after 1 January 2009, with earlier application permitted.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- they are 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

- they 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.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendments and, accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
Basis for Conclusions

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards and IAS 27 Consolidated and Separate Financial Statements: Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*.*

In its comment letters 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 not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser 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 Interpretation. Another reason for a difference is that EFRAG's thinking may evolve.

1 When evaluating the merits of the Amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (the Amendments), EFRAG considered the following 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 Having formed tentative views on the issues and prepared a draft assessment, EFRAG issued that draft assessment on 30 May 2008 and asked for comments on it by 1 July 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

3 In addition to amending IFRS 1 and IAS 27, the Amendments make consequential amendments to IAS 18 *Revenue*, IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IAS 36 *Impairment of Assets*.

(a) EFRAG considers the amendments made to IAS 18 and IAS 21 to be a consequence of the amendments to IAS 27 and, as a result, not in need of separate evaluation.

(b) The amendment to IAS 36 does not change the requirements of the standard; it merely provides additional guidance as to the 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 EFRAG started its assessment by asking whether the Amendments are consistent with the Framework. 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 the recognition of income and the 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 measurement bases that entities are currently using but does not describe how assets and liabilities should be measured. As such, EFRAG believes that the question of whether a measurement basis required by the Amendments 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's right to receive a dividend from its investment in a subsidiary, jointly controlled entity or associate is established, 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 and that, because there is not a directly-related decrease in another assets or increase in a liability, the right to receive a dividend represents income as defined in paragraph 92 of the Framework. Therefore, in EFRAG's view this accounting is consistent with the definition of 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.

EFRAG understands that these difficulties above are preventing some investors adopting IFRSs in their separate financial statements.

8 In EFRAG's view, the Amendments provide significant relief from those difficulties and, as a result, will make it easier for investors to adopt IFRSs in their separate financial statements. That is likely to mean that more entities with investments in subsidiaries, jointly controlled entities and associates will adopt IFRS in their separate financial statements. EFRAG believes that this will result in a general improvement in the quality of financial reporting.

9 EFRAG has also evaluated the impact of the Amendments on the specific information provided about investments in subsidiaries, jointly controlled entities and associates.

Comparability

Deemed cost

10 By allowing 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, the Amendments have the effect of allowing such investments to 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 have an impact on comparability, both among first-time adopters applying this exemption and between future adopters of IFRS and entities already applying IFRSs.

11 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. The more entities applying the same set of standards, the more comparable financial statements are in general.

12 Existing IFRS 1 contains a similar exception from IFRS 3 for the restatement of business combinations at the date of transition to IFRSs. The Amendments extend 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

13 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 returns on such investments will be accounted for in the same way by all entities under the Amendments, regardless of the reserves the dividends are paid out of.

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

14 Requiring, 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 of the information provided 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

15 Currently, IFRS requires first-time adopters to measure their investments in subsidiaries, jointly controlled entities and associates at the date of transition to IFRSs 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. Henceforth, such investments could be measured by the investor in its separate financial statements on any one of four bases mentioned in paragraph 10 above. In addition, all dividends received from such entities are treated as income; the notion of paying dividends out of pre- or post-acquisition profits is eliminated and instead the focus is on whether the payment of the dividend might have resulted in the investment becoming impaired.

16 In EFRAG's view, 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. The treatment of dividends from such investments will be different from before, but EFRAG believes in many ways it will be more understandable because of the shift in focus away from a pre- and post-acquisition reserves approach to an income and impairment approach.

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

17 When a group reorganisation of the type described in the Amendments is undertaken, nothing of substance has happened. In such circumstances, one would not expect there to be an accounting effect. As that will be the result under the Amendments, EFRAG believes the Amendment relating to group reorganisations is understandable.

Relevance and reliability

18 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. In some cases this make it more likely that an impairment loss will need to be recognised;

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

19 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 allowed when transitioning to IFRS—are considered to be less relevant. On the other hand, this amendment (together with the one described in paragraph 18(b) above) makes it possible for more entities to adopt IFRS in their 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 18(b) above is a different way of accounting for dividends, EFRAG's assessment is that it will not result in less relevant information and could result in an improvement in the relevance of the information provided.

(c) In EFRAG's view, the effect described in paragraph 18(c) above has no implications for the relevance of the information provided; it is a clarification of an existing requirement.

20 EFRAG has also considered the effect that the changes described in paragraph 18 might have on the reliability of the information provided.

(a) EFRAG believes that the amendment described in paragraph 18(a) above is likely to have the effect of improving the reliability of the measures used, because for some entities wishing to transition to IFRS but not currently measuring their investments in subsidiaries, jointly controlled entities and associates at cost it was previously difficult 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 basis used is required to be disclosed, so in EFRAG's 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 assessment is that the change described in paragraph 18(b) above will not have a significant effect on the reliability of the information provided. It is a different way of representing the dividends received from investments, but does not raise any reliability issues.

(c) In EFRAG's view, the effect described in paragraph 18(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. For entities that will have to change their accounting, EFRAG believes it will involve using a measure that is easier to estimate and therefore likely to be more reliable.

Conclusion

21 For the above reasons, EFRAG has 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?

22 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 Amendments:

(a) are 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) 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.

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

23 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.

24 EFRAG has also concluded that there is no reason to believe that the information resulting from the application of the Amendments would be contrary to the true and fair view principle or that it would not be in the European interest to adopt them.

Conclusion

25 For the reasons set out above, EFRAG has concluded that the Amendments satisfy the criteria for EU endorsement and that EFRAG should recommend their endorsement.