Accounting Standards Board

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Stig Enevoldsen
Chairman
European Financial Reporting Advisory Group
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20 April 2007

Dear Stig

Exposure Draft of proposed amendment to IFRS 1 'First time adoption of International Financial Reporting Standards: Cost of an Investment in a Subsidiary'

Thank you for allowing us the opportunity to comment on the draft comment letter to the IASB regarding the proposed amendment to IFRS 1. I attach to this letter a copy of the response that the ASB has sent to the IASB.

The ASB, in general, agrees with the comments made by EFRAG in the draft comment letter. We also welcome the proposed amendment. Whilst we welcome the proposed amendment that provides transitional relief we have highlighted in our response to the IASB that we consider the root of the problem stems from the cost method in IAS 27 'Consolidated and Separate Financial Statements'.

We have also set out in our letter to the IASB that further consideration should be made to using the cost as recorded in accordance with previous GAAP as the deemed cost. It is our view that the information content of this amount is superior to an amount that is based on net assets at transition. We consider that whilst net assets at transition may provide useful information in the first year of transition in any future period the amount has little, if any, information value. We have formed this view particularly as entities may opt to apply International Financial Reporting Standards at different dates and hence the transition date is not a particular reference date.

Yours sincerely

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Jeff Singleton
International Accounting Standards Board
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20 April 2007

Dear Jeff

Exposure Draft of proposed amendment to IFRS 1 'First time adopting of International Financial Reporting Standard: Cost of an Investment in a Subsidiary'

I am writing with the comments of the Accounting Standards Board (ASB) in response to the above exposure draft. The ASB welcomes the proposals in the exposure draft to grant relief on transition to International Financial Reporting Standards (IFRS). The ASB considers that the provisions set out in the exposure draft will provide relief to some UK entities that have chosen to retain UK GAAP rather than converge with IFRS. The appendix sets out our responses to the questions in the exposure draft. This covering letter highlights the main points that the ASB wishes to raise.

We note that the exposure draft proposes that on transition to IFRS a parent entity may elect to use a deemed cost to measure some or all or its investments; the deemed cost being either the net assets of the subsidiary based on IFRS or fair value. Prior to considering the proposal set out in the exposure draft we would like to note that we do not consider the issue being addressed is merely a first time adoption issue. We consider the root of the issue is in the description of the "cost method" in IAS 27 'Consolidated and Separate Financial Statements'. The cost method in IAS 27 draws a distinction between distributions that are considered to be a "return of" the investment as opposed to a "return on" the investment. In our view this distinction lacks conceptual merit. Application of this requirement requires an arbitrary assumption to determine what profits dividends are paid out of—usually that profits are paid out of post-acquisition profits first. It is our view that the underlying principle is that investments should not be stated at an amount in excess of recoverable amount.

We would therefore have preferred the IASB to amend the cost method in IAS 27 removing the distinction between "return of" and "return on" the investment, rather than provide only transitional relief.

Our comments regarding the proposals in the exposure draft are set out below.

In relation to the proposal to use the net assets on transition we are concerned that this proposal does not take into consideration the "goodwill" that is part of the investment cost held by the parent entity. We consider that, in certain circumstances, this may give rise to a parent entity being required to write-down the carrying value of its investments. In the UK this would have the affect of reducing future profits that are available for distribution. We consider that this disadvantage is of such significance that the objective of the exposure draft (to provide relief on transition) may in some instances be negated. As a consequence, we consider the IASB should reconsider its proposals and consider two alternative options:

(i) use the amount as recorded for the subsidiary under previous GAAP; or

(ii) use the carrying amount of the subsidiary's assets less liabilities in accordance with IFRS, plus historical goodwill as recorded under previous GAAP.

In relation to option (i) above we note that paragraph BC4 of the exposure draft states:

> "In some situations, the cost of an investment in a subsidiary determined in accordance with an entity's previous GAAP bore little resemblance to cost in accordance with IAS 27. Therefore the Board rejected the use of a deemed cost based on previous GAAP cost because it would provide less useful information that the other two methods proposed."

In our view this extract contains two independent concerns; the first is that cost according to previous GAAP may have little resemblance to cost in accordance with IAS 27 and the second that this information is less useful than the two alternative proposals.

In relation to the first concern it is our view that it is not necessarily true that in the UK previous GAAP will have little resemblance to cost in accordance with IAS 27. We agree that in the UK relief is provided in certain circumstances from requiring entities to record share premium on the acquisition of the subsidiary in pursuant to section 131 of the UK Companies Act 1985. The relief provided by section 131 is available only in certain circumstances. It is only in the circumstances that relief is available that cost will be below an equivalent IFRS amount. It is in these circumstances that the information to apply the cost method is unlikely to be available, since cost may not have been determined at the acquisition date.

As regards the second concern noted above (that the information is less useful than the two alternative proposals) we consider that this reasoning is inconsistent with the relief currently available in IFRS 1, where the entity is not required to restate business combinations. Specifically, we consider that where goodwill is calculated as the difference between cost and the fair value of the net assets acquired then the relief is not dissimilar to that suggested above.

In relation to our second option suggested above (IFRS net asset plus goodwill) this would overcome the issue of parent entities being required to write down an

investment. It is, in our view, also consistent with the relief currently provided in IFRS 1 not to restate business combinations. We note that the IASB did consider this option but decided not to proceed with it based on conversations with constituents. We believe that the option should have been explored further and at least discussed in the exposure draft. This would have been the normal due process.

In summary the ASB welcomes the proposals and considers that they will provide relief to some UK entities, although we would have preferred a solution that amended the cost method in IAS 27. Where the IASB are unable to reconsider the definition in IAS 27 we consider two alternative options for transitional relief should be considered:

(i) use the previous GAAP amount; and
(ii) include the historical amount of goodwill as part of the investment cost.

Should you have any questions regarding the proposals please do not hesitate to contact Michelle Crisp or myself.

Yours sincerely

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APPENDIX

Question 1

IAS 27 requires a parent, in its separate financial statements, to account for an investment in a subsidiary either at cost or at fair value (in accordance with IAS 39 Financial Instruments: Recognition and Measurement). However, the Board believes that in some cases, on first-time adoption of IFRSs, the difficulties in determining cost in accordance with IAS 27 exceed the benefit to users.

This Exposure Draft proposes to allow a parent, at its date of transition to IFRSs, to use a deemed cost for an investment in a subsidiary. The deemed cost would be determined using either the carrying amount of the net assets of the subsidiary, or its fair value, at that date. Is this appropriate? If not, why?

We agree a deemed cost based on fair value or net assets provides some relief and therefore we welcome the proposals. As set out in the covering letter, we do, however, have a concern that the net asset approach as proposed in the exposure draft will not be effective, as it fails to take into consideration the goodwill which is held as part of the investment cost in the parent entity's financial statements. We therefore propose alternative solutions should be considered.

In relation to the proposal to use as deemed cost the fair value we consider this option may not be popular with constituents due to the costs involved in estimation of the fair value for subsidiaries. It might be noted that most subsidiaries will not have readily determinable market values but require separate valuations to be undertaken. Undertaking these valuations will also be complicated where there are vertical groups involved.

On a rather more detailed level we note that:

(i) in paragraph B5(a), it is stated that deemed cost may be the interest in the carrying amount of the subsidiary's assets less liabilities, using the carrying amounts that IFRSs would require in the subsidiary's balance sheet. We note, however, that IFRS 1 paragraph 24 permits a subsidiary adopting IFRS at a later date than its parent that it may measure its assets and liabilities at either its date of transition or adopt the amounts included in the parent's consolidated financial statements, based on the parent's date of transition. We recommend that clarification as to which net assets are being referred to should be made.

(ii) the exposure draft addresses only subsidiaries. We consider the exposure draft should also address associates and joint ventures.

(iii) we recommend the exposure draft is amended to specify whether the IFRS net assets to be used should be determined at entity level (i.e. net assets of the subsidiary including carrying values of its subsidiaries in accordance with IFRS) or at a sub-consolidation level. Where a sub-consolidation is required we note some practical guidance as to the treatment of goodwill is required.

Question 2

The cost method in IAS 27 requires a parent to recognise distributions from a subsidiary as a reduction in the cost of the investment to the extent they are received from the subsidiary's pre-acquisition profits. This may require a parent, in some cases, to restate the subsidiary's pre-acquisition accumulated profits in accordance with IFRSs.

Such a restatement would be tantamount to restating the original business combination, requiring judgements by management about past conditions after the outcome of the transaction is known.

This Exposure Draft proposes a simplified approach to determining the pre-acquisition accumulated profits of a subsidiary for the purpose of the cost method in IAS 27. Is this appropriate? If not, why?

In the context of the proposals set out in the exposure draft the ASB agrees with the proposed relief.