

**Draft comment letter for comments by 26 February 2008
to Commentletter@efrag.org**

March 2008
IFRS 1 and IAS 27 Amendments
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir/Madam,

Exposure Draft of Proposed 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*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft of Proposed 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* (the ED). This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

It can be difficult for an entity applying IFRS for the first time in its separate financial statements to comply with certain of the 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. The objective of the ED is to provide some relief from those requirements. The ED follows an earlier ED (issued in January 2007) that also sought to provide some relief from the requirements. When we responded to that earlier ED (in our comment letter dated 15 June 2007) we agreed that relief was needed, but had some concerns about the relief proposed. We are pleased that the IASB has taken the decision to make changes to the relief it proposed earlier and to issue a second ED on the subject.

Draft comment letter on Proposed Amendment to IFRS 1 and IAS 27

EFRAG supports the amendments to IFRS 1 and IAS 27 proposed in the ED [, although it has some concerns about the proposal that the receipt of a dividend from a subsidiary, jointly-controlled entity or associate of the entity should always trigger an impairment test of the entity's investment]. The proposals address fully the concerns we raised in our earlier letter. We believe the new proposals will reduce the cost of adopting IFRSs in the parent separate financial statements, and that may mean that more parent entities will apply IFRSs in both the separate financial statements and consolidated financial statements.

We have a few detailed comments. They are set out in the appendix to this letter.

If you would like further clarification of the points raised in this letter, please do not hesitate to contact Charlotte Norre or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

APPENDIX

Question 1—Deemed cost

The exposure draft proposes to allow an entity, at its date of transition to IFRSs in its separate financial statements, to use a deemed cost to account for an investment in a subsidiary, jointly controlled entity or associate. The exposure draft proposes that an entity may choose as the deemed cost of such investments either the fair value or the previous GAAP carrying amount of the investment at the entity's date of transition to IFRSs (see paragraphs 23A and 23B of the draft amendments to IFRS 1 and paragraphs BC8–BC13 of the Basis for Conclusions).

Question 1: Do you agree with the two deemed cost options as they are described in this exposure draft? If not, why?

- 1 We agree that some relief should be granted from the existing requirements in IFRS 1 that apply when a first-time adopter is determining the cost of an investment in a subsidiary, jointly controlled entity or associate in accordance with IAS 27.
- 2 We believe that the proposals—by allowing an entity to use the previous GAAP carrying amount of the investment in a subsidiary, jointly controlled entity or associate as deemed cost at date of the parents transition to IFRSs in its separate financial statements—address fully the concerns we expressed in our comment letter dated 15 June 2007. We support the proposed amendments and agree with the IASB that they will reduce the cost of adopting IFRSs in parent financial statements significantly.

Question 2—Change in scope

The exposure draft proposes that the deemed cost option should be available for the initial measurement of investments in jointly controlled entities and associates when an entity adopts IFRSs in its separate financial statements (see paragraph BC14 of the Basis for Conclusions).

Question 2: Do you agree with the proposal to allow the deemed cost option for investments in jointly controlled entities and associates? If not, why?

- 3 We agree with the proposal to allow the deemed cost option for investments in jointly controlled entities and associates. It seems logical and is consistent with the present exemption for business combinations in IFRS 1.B3 and the guidance in IFRS 1.24 and 1.25 on the measurement of assets and liabilities of subsidiaries, which also apply to associates and joint ventures.

Questions 3 and 4—Cost method

The exposure draft proposes to delete the definition of the 'cost method' from IAS 27. Additionally, the exposure draft proposes to amend IAS 27 to require an investor to recognise as income dividends received from a subsidiary, jointly controlled entity or associate in its separate financial statements. The receipt of this dividend requires the investor to test its related investment for impairment in accordance with IAS 36 Impairment of Assets (see paragraphs 4

and 37B of the draft amendments to IAS 27 and paragraphs BC15–BC20 of the Basis for Conclusions).

Question 3: Do you agree with the proposal to delete the definition of the ‘cost method’ from IAS 27? If not, why?

- 4 We agree with the proposal to delete the definition of the “cost method” from IAS 27. We believe that, by deleting this definition and in its place proposing that any dividends paid by a subsidiary, jointly controlled entity or associate to its parent entity shall be recognised as income by the parent in its separate financial statements (see question 4), the number of cases where the previous GAAP cost will be based on same principles as those underlying the IAS 27 numbers will increase. This means that for some parent entities it will no longer be necessary to apply a deemed cost as proposed in the ED (because previous GAAP cost would comply with the amended IAS 27).

Question 4: Do you agree with the proposed requirement for an investor to recognise dividends received from a subsidiary, jointly controlled entity or associate as income and the consequential requirement to test the related investment for impairment? If not, why?

- 5 We agree with the proposal to recognise all dividends received from a subsidiary, jointly controlled entity or associate as income (rather than the return of some of the investment). We believe this will simplify the accounting.

Questions to EFRAG’s constituents:

Mandatory impairment test of the investment at each payment of dividend

It is proposed in paragraph 37B in the ED that, if an investor accounts for its investments in the subsidiary, jointly controlled entity or associate at cost in accordance with IAS 27, the receipt of a dividend from such investments is an event that requires the investor to test the related investment for impairment in accordance with IAS 36 *Impairment of Assets*. The required test of impairment is independent of whether there is any indication of impairment. This would mean an impairment test would have to be carried out every time a dividend is received from such an investment, even if the entity paying the dividend has substantial accumulated reserves relative to the dividend being paid. Furthermore, because the amendment is being made to IAS 27 rather than in IFRS 1, this would apply not only related to entities transitioning to IFRSs but to all entities applying IFRSs that have such investments. This imposes a new requirement on entities already applying IFRSs because, although investments in subsidiaries, jointly controlled entities and associates are already in the scope of IAS 36 *Impairment of Assets*, currently they are required to perform an impairment test only if there is an indication that there might have been an impairment; under the proposals they would need to perform the test every time a dividend is received from such investments.

EFRAG has discussed whether this 'mandatory impairment test' for all entities receiving dividends from an investment in subsidiaries, jointly controlled entities and associates will be unduly burdensome. One view is that it will not be very burdensome because, when there has not been an impairment, there will often be plenty of easily obtainable evidence indicating that that is the case. Paragraph 23 of IAS 36 allows estimates, averages and computational short cuts as reasonable approximations of the detailed computations illustrated in IAS 36 for determining fair value less costs to sell or value in use. Another view is that it will often be necessary to carry out a full computation to comply with IAS 36 requirements and that will often be burdensome. Those EFRAG members who believe that mandatory impairment testing of the investments on each dividend payment will be burdensome note that paragraph 9 of IAS 36 already requires entities to assess at each reporting date whether there is any indication that an asset may have been impaired; they think that, rather than require a mandatory impairment test, it should be sufficient to enhance the existing test in paragraph 9, perhaps by stating that the payment of significant dividends relative to the accumulated reserves should be an indicator for the purposes of paragraph 9 or by incorporating an objective evidence that the asset has been impaired' test similar to that set out in paragraph 58 of IAS 39.

- 1 Do you believe mandatory impairment test of the investment of each payment of dividend as currently drafted will be unduly burdensome or will it in practice not be a problem?
- 2 If you think a mandatory impairment test will be unduly burdensome, how do you suggest that the IASB restricts the possibility that dividends are not recognised as income when they are returns of the investment (rather than on the investment)?

Question 5—Formation of a new parent

The exposure draft proposes that in applying paragraph 37(a) of IAS 27 to the formation of a new parent, the new parent should measure cost using the carrying amounts in the separate financial statements of the existing entity at the date of the formation (see paragraph 37A of the draft amendments to IAS 27 and paragraphs BC21 and BC22 of the Basis for Conclusions).

Question 5: Do you agree with the proposed requirement that, in applying paragraph 37(a) of IAS 27, a new parent should measure cost using the carrying amounts of the existing entity? If not, why?

- 6 We support the objective of the proposed requirement. Our understanding (based on BC22) is that it should apply in a very limited range of circumstances only. We agree. However, we are concerned that more arrangements might fall within the scope of the proposed wording of IAS 27.37A than BC22 seems to envisage. We suggest that the circumstances to which the paragraph will apply are described in more detailed in the paragraph to avoid unintended application of the paragraph.

Question 6—Transition

The exposure draft proposes that the amendments to IFRS 1 and IAS 27 shall be applied prospectively.

Question 6: Do you agree that prospective application of the proposed amendments to IFRS 1 and IAS 27 is appropriate? If not, why?

- 7 We agree that the proposed amendments to IFRS 1 should be applied prospectively.

Question to EFRAG's constituents:

Prospective or retrospective application of the proposed amendments to IAS 27

It is proposed in paragraph 43B in the ED that the proposed amendments to IAS 27 (ie the deletion of the cost method definition, the new requirement to treat all dividends from subsidiaries etc as income, and the paragraph dealing with group reorganisations) shall be applied prospectively. That means, for example, that entities already applying IFRSs at the effective date of the proposed amendments will thus until this date, if applying the present cost method in IAS 27, recognise dividends from, say, subsidiaries as income only to the extent that the investor receives distributions from retained earnings after the date of acquisition. (Distributions received in excess of such profits would be regarded as a recovery of investment and are recognised as a reduction of the cost of the investment.) Then, from the effective date, all the dividends from the subsidiary will be treated as income but will trigger an impairment test.

It follows that entities that are identical in all respects except that they transition at different dates to IFRS could recognise different amounts of the dividends they receive as income and could have different amounts of distributable reserves. Some think this is unfair. Others argue that there is nothing unique about these proposed amendments; transitioning at different dates often results in different accounting numbers.

On the other hand, allowing retrospective application would not prevent this being the case. And requiring retrospective application would mean that all entities applying the present cost method in IAS 27 would be required to restate the prior year numbers so that all dividends from subsidiaries etc are accounted for as income and mandatory impairment tests are carried out in respect of the dividends received in the periods presented. (Impairment tests do not need to be carried out for earlier periods because earlier impairment losses can be reversed in accordance to IAS 36 if the investment is no longer impaired.) The IASB has to date tried to ensure that impairment tests are not affected by hindsight.

Bearing the above arguments in mind, do you believe that that the proposed changes to IAS 27 should be applied prospectively (as proposed in the ED) or retrospectively or should a choice be allowed?

Comments on consequential amendments to other IFRSs

- 8 We agree with the amendments to other IFRSs proposed in the ED with one exception.
- 9 The ED proposes to amend paragraph 32 of IAS 18 *Revenue* as follows:

32	When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognised as revenue. When dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.
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- 10 It seems to us that, since the issuance of IAS 39 and its effective interest method requirements, the sentence that has not been deleted has probably been redundant. (In paragraph 30 of IAS 18 it is required to recognise interest using the effective interest method in IAS 39. The effective interest method is allocating the interest over the relevant period.) We therefore believe that the first part of paragraph 32 can be deleted.