EFRAG

European Financial Reporting Advisory Group

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

7 November 2008

Dear Mr Holmquist

Adoption of the Amendment to IAS 27 *Consolidated and Separate Financial Statements*

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 Amendment to IAS 27 *Consolidated and Separate Financial Statements* (IAS 27A), which was published by the IASB on 10 January 2008. It was issued as an Exposure Draft in June 2005 and EFRAG commented on that draft.

IAS 27A specifies the circumstances in which an entity must prepare consolidated financial statements and the accounting treatments to be applied when there have been changes in the level of ownership interest in a subsidiary and or a loss of control of a subsidiary.

The main changes made by IAS 27A to existing IAS 27 are summarised in paragraph 3 of Appendix 1 of this letter.

The amendments being introduced through IAS 27A become effective for annual periods beginning on or after 1 July 2009, with earlier application permitted subject to the application from that same earlier date of the revised IFRS 3 *Business Combinations*.

EFRAG has carried out an evaluation of IAS 27A. 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 IAS 27A and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards that:

- it 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

- it 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.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IAS 27A and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix 1 - Basis for Conclusions'.

A minority of EFRAG members (two) have concerns about IAS 27A that cause those members to believe that EFRAG should not recommend IAS 27A for endorsement. The reasoning of those members is explained in the attached 'Appendix 2—Dissenting View'.

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 1
BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on IAS 27A.

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 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 IAS 27A, EFRAG considered the following key questions:

   (a) Are the requirements of IAS 27A consistent with the IASB's *Framework for the Preparation and Presentation of Financial Statements* ('the Framework')?

   (b) Would IAS 27A's implementation result in an improvement in accounting?

   (c) Does the accounting that results from the application of IAS 27A meet the criteria for EU endorsement?

2 Having formed tentative views on the above issues and prepared a draft assessment, EFRAG issued that draft assessment on 30 July 2008 and asked for comments on it by 19 September 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 IAS 27A in effect proposes three amendments to existing IAS 27, all of which affect the accounting treatment of Non-controlling Interests (NCI). They relate to:

   (a) the accounting for changes in ownership interests in subsidiaries that do not result in control of another entity being lost (Amendment 1).

   Existing IAS 27 is silent on how to account for changes in ownership interest that do not involve a loss of control in the subsidiary.

   IAS 27A treats transactions between the parent and the NCI holders as being transactions that do not involve the reporting entity; therefore any 'gains' or 'losses' are treated as movements between components of equity and are not recognised in profit or loss.

(b) the accounting for changes in ownership interests in subsidiaries that result in control of another entity being lost (Amendment 2).

Existing IAS 27 requires any equity interest retained in the former subsidiary to be measured at its carrying amount (i.e. no remeasurement is required). This means that, when control is lost, a gain or loss is recognised only for the 'realised' portion of the interest disposed of.

IAS 27A requires a parent entity to measure any retained investment in the former subsidiary at fair value when it loses control of that subsidiary. It further requires any difference between the carrying amount of the retained investment immediately prior to losing control and its fair value to be recognised in profit or loss, along with any gain or loss on the interest disposed of. It clarifies that the gain or loss arising on loss of control of a subsidiary includes the parent's share of gains and losses relating to the former subsidiary's assets and liabilities that were recognised previously in equity.

(c) the allocation of losses to controlling and non-controlling interest in a subsidiary (Amendment 3).

Existing IAS 27 requires losses in a subsidiary that exceed the NCI interest to be allocated to NCI only if the NCI have a binding agreement to fund the losses. In the absence of such an agreement, the losses are attributable to the controlling interest only. If the subsidiary subsequently reports profits, these profits are allocated to the controlling interest until the share of losses previously absorbed by the controlling interest have been recovered.

IAS 27A changes the way losses are allocated between the parent and NCI by requiring profit or loss for the period and other comprehensive income to be attributed to the parent and to the NCI in proportion to their ownership interests. This accounting will apply even if it results in NCI having a deficit balance.

Are the requirements of IAS 27A consistent with the IASB's Framework?

4 EFRAG considered whether the requirements of IAS 27A are consistent with the IASB's Framework. For this purpose, it focused on the main changes described in paragraph 3.

5 EFRAG believes there are several aspects of the Framework that are of particular relevance to this consideration.

(a) The qualitative characteristics of financial information are relevance, reliability, comparability and understandability. As IAS 27A will be judged against the qualitative characteristics later in this appendix, this section does not focus on that aspect of the Framework.

(b) The Framework definitions of 'liability and 'equity'.

(c) The Framework definitions of 'income' and 'expenses', and its explanation that contributions from equity holders are not income and distributions to equity holders are not expenses.

Amendment 1—Changes in ownership interest that do not result in control of another entity being lost

6 Under the Framework, a Non-controlling Interest is equity—which is also how it is classified under both IFRS 3R and IFRS 3. A transaction that involves a change of ownership without loss of control is therefore a transaction between equity holders. Under IAS 27A, any 'gain' or 'loss' that arises on a change in ownership interest that does not involve a loss of control is treated as an increase or decrease in equity that is not income or expense. The question that EFRAG therefore considered was whether it was consistent with the Framework to treat these 'gains' and 'losses' arising from transactions between equity holders as something other than income and expenses.

7 The Framework defines 'income' and 'expenses' in terms of changes in ownership interest that do not relate to distributions to equity participants. It does not however define what it means by 'a contribution from an equity participant' or 'a distribution to an equity participant'. Although 'gains' ('losses') arising from changes in ownership interest that do not involve a loss of control will clearly result in an increase (decrease) in equity, it is not clear whether the increases and decreases relate to contributions from or distributions to equity participants. Typically, a contribution from an equity participant will involve that participant giving something of value to the entity and receiving in return an equity interest, but that is not necessarily always the case.

8 EFRAG's view therefore is that the Framework is not definitive on the issue, so Amendment 1 is not inconsistent with the Framework.

Amendment 2—Changes in ownership interest that result in control of another entity being lost

9 EFRAG considered whether the treatment required by Amendment 2—when the parent has disposed of an interest in another entity and, as a result, loses control of that second entity—is consistent with the Framework definitions of 'income' and 'expense'.

10 When changes in ownership interest that do not involve a loss of control were considered earlier, EFRAG noted that we were discussing a transaction between equity participants. That would not be true in this case, so the possibility of any 'gain' or 'loss' arising on the transaction being a contribution from or distribution to equity participants also does not appear to arise. Thus, EFRAG believes it is consistent with the Framework to treat the 'gain' or 'loss' as income and expense.

Amendment 3—Accounting for losses attributable to NCI

11 The Framework does not directly address the allocation of income and expenses between the different components of equity. As a result, EFRAG believesthe Amendment 3 is not inconsistent with the Framework.

Conclusion

12 Having taken the above considerations into account, EFRAG concluded that IAS 27A was not inconsistent with the IASB's Framework.

Would IAS 27A's implementation result in an improvement in accounting?

13 EFRAG then asked itself whether the application of IAS 27A was likely to result in an improvement in the information provided to users.

Amendment 1—Changes in ownership interest that do not result in control of another entity being lost

14 EFRAG understands that currently at least six different methods are being applied in practice to account for changes in ownership interest without loss of control. IAS 27A requires a single approach to be applied.

15 EFRAG believes that adopting a single approach will significantly improve the comparability of the financial information reported in the consolidated financial statements, as all entities will now account for changes in ownership interest in controlled subsidiaries in the same way.

16 However, it is always possible that the single approach required is not an appropriate approach. EFRAG considered whether that is the position in this case. EFRAG members had differing views on the issue and attached different weights to those views.

17 Some EFRAG members had concerns as to whether Amendment 1 required the most appropriate accounting. In their view:

(a) An approach whereby more goodwill (and more net assets) would be recognised on further acquisitions might have resulted in better information, at least in some circumstances. These EFRAG members noted that it could be questioned why goodwill can be measured only once—at the date control had been initially achieved—particularly when the NCI had been initially measured at its proportionate interest in the net assets acquired instead of at fair value. In their view, it would be better accounting were additional goodwill recognised when a parent acquires further interest in a subsidiary.

(b) It is more appropriate to recognise the 'gains' and 'losses' that arise on transactions that involve changes in ownership in profit or loss rather than as an equity movement. Recognising the 'gains' and 'losses' as an equity movement could result in them being obscured from view. In the view of these EFRAG members, NCI holders do not always share in the same risks and benefit from the same rewards as the parent entity shareholders. Thus it was not clear to those members why NCI holders should always be treated in the same way as the parent entity shareholders, and consequently why the equity of the "group" should be affected when additional interest was acquired or disposed of.

(c) the most appropriate accounting might also depend on which option had been selected to measure NCI initially under IFRS 3R.

18 However, other EFRAG members thought the accounting required by Amendment 1 represented an improvement in accounting. In their view:

(a) It is well-accepted practice to base the accounting in the area of acquisitions on whether control exists. If control exists, the acquiree's assets and liabilities are treated, for the purposes of the consolidated financial statements, as if they are the acquirer's assets and liabilities. For this purpose, an entity either has control or it does not have control. It would seem rather odd to recognise "more assets" when a controlling interest is increased further.

(b) Existing accounting is a mixture of two perspectives—the economic entity perspective and the parent perspective—that are based on different accounting models and produce different accounting outcomes when applied to transactions between a parent and the NCI. The use of a "mixture" of two fundamentally different perspectives has created accounting inconsistencies in the way some transactions are accounted for in the consolidated financial statements. Amendment 1 eliminates those inconsistencies.

19 On balance, the majority of EFRAG members believe the specific accounting required by Amendment 1 is an improvement compared to the alternatives. Taking the improvement in comparability into account, the majority also believes that the Amendment will improve the quality of the information provided.

Amendment 2—Changes in ownership interest that result in control of another entity being lost

20 EFRAG agrees that Amendment 2 will require entities to measure the gain or loss on a consistent basis, thereby also requiring a consistent basis for determining the initial value of the retained investment. This will increase the comparability of the information provided both when control in the subsidiary is lost and when the retained investment is recognised for the first time in the consolidated financial statements.

21 Again, the issue is whether this enhanced comparability has been achieved by adopting a single approach that is not an improvement on the alternatives. EFRAG considered that issue. EFRAG members had differing views on the issue and attached different weights to those views.

22 Some EFRAG members believed the accounting required is an improvement on the alternatives. In their view:

(a) On the loss of control, the parent-subsidiary relationship ceases to exist—so from the group's perspective the parent should derecognise what it had recorded in its books (the individual assets, liabilities and equity related to that subsidiary)—and a new interest in the former subsidiary has been acquired. In other words, a non-cash asset has been exchanged for cash and/or another non-cash asset. In such circumstances, the usual accounting is to value the non-cash assets and take the overall profit or loss on the transaction to profit or loss.

(b) The parent's share of gains and losses relating to those assets and liabilities that were recognised previously in equity should to be recognised in profit or

loss when control of the subsidiary to which the net assets relate to is lost. The Amendment ensures that the accounting is consistent with the way 'recycling' from equity is accounted for in third party transactions, for example when a subsidiary sells an available-for-sale financial asset. Requiring accounting on loss of control that is consistent with the accounting for selling the individual net assets to a third party is an improvement; in both cases the economics of the exchange are the same, so there is no reason why the accounting should be different.

(c) The amendment aligns the accounting for loss of control with the changes in the IFRS 3R relating to remeasurement of the previously held interest when a parent achieves control of a subsidiary in a step acquisition.

23 On the other hand, the majority of EFRAG members thought it would be wrong to recognise a gain or loss in profit or loss on the retained interest when a parent loses control of a subsidiary, because an exchange transaction with a third party has not taken place.

24 Overall, all EFRAG members agree that Amendment 2 enhances comparability, but the majority of EFRAG members think the accounting it requires is not the most appropriate of the alternatives available.

Amendment 3—Accounting for losses attributable to NCI

25 A majority of EFRAG members believe that Amendment 3 will improve the information provided because it eliminates an inconsistency in existing IAS 27 by aligning the accounting for allocation of losses to NCI with the requirement to classify NCI as equity.

26 However, some members do not. In their view, the accounting for loss allocation in existing IAS 27 reflects better how the losses will be borne in practice, unless there is a contractual agreement whereby they have agreed to meet those losses.

Does the accounting that results from IAS 27A's application meet the criteria for EU endorsement?

27 As explained above, all EFRAG members believe that IAS 27A is not inconsistent with the Framework. Having considered whether the various amendments in IAS 27A were likely to improve the information provided:

(a) the majority of EFRAG members believe that Amendment 1 will improve the quality of the information provided;

(b) all EFRAG members agree that Amendment 2 enhances comparability, but the majority of EFRAG members think the accounting it requires is not the most appropriate of the alternatives available; and

(c) a majority of EFRAG members believe that Amendment 3 will improve the information provided.

28 EFRAG then considered whether IAS 27A meets the requirements of the European Parliament and of the Council on the application of international accounting standards, in other words that IAS 27A:

(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 IAS 27A.

Relevance

29 According to the Framework, information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

30 The majority of EFRAG members believe that IAS 27A will result in information that is relevant to the needs of users of financial statements, and that it will not result in relevant information being omitted from the financial statements.

Reliability

31 The existing Framework explains that information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32 EFRAG considered whether the implementation of IAS 27A would result in reliable information being included in the financial statements. The only potential concern EFRAG identified arose from the new requirement to measure the NCI retained at fair value when control is lost. However, most EFRAG members believe that in most cases the remeasurement to fair value will be made when the parent decides to sell its controlling interest in the subsidiary, and at that time most of the information required to estimate the fair value of the NCI should be available. For this reason, EFRAG concluded that reliability was not a significant concern.

Comparability

33 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

34 The enhancements to the comparability of the information that IAS 27A achieves have already been mentioned.

(a) It introduces requirements on the accounting treatment of changes in ownership interest that do not involve a loss of control, an area where,

EFRAG understands, a number of different methods are being applied in practice.

(b) IAS 27A will clarify some aspects of accounting for loss of control, thereby reducing the divergence in practice and enhancing the comparability of the information provided.

(c) It aligns the accounting for transactions that result in loss of control in a subsidiary with the accounting in the revised IFRS 3 on achieving control in a subsidiary.

35 The requirement to apply the amendments prospectively will have a negative impact on comparability, but nevertheless EFRAG believes the comparability criterion will be met.

Understandability

36 Financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

37 Although IAS 27A introduces some new notions and will require users to look at aspects of a set of consolidated financial statements in a different way than hitherto, the majority of EFRAG members did not have any concerns about the understandability of the information that would be provided by applying IAS 27A

True and fair

38 For the reasons set out above, the majority of EFRAG members see no reason to believe that IAS 27A is inconsistent with the true and fair view requirement.

European interest

39 EFRAG considered whether the benefits of implementing IAS 27A in the EU exceed the costs of doing so. On balance, EFRAG concluded that the benefits that are expected to arise from implementing IAS 27A in the EU will exceed the costs expected to be incurred to implement IAS 27A.

Conclusion

40 For the reasons set out above, the majority of EFRAG members have concluded that on balance IAS 27A satisfies the criteria for EU endorsement. EFRAG therefore recommends its endorsement.

APPENDIX 2
DISSENTING VIEW

The views of two EFRAG members who voted against recommending endorsement of IAS 27A are explained in this appendix.

Two EFRAG members (Mr Michael Starkie and Mr Carsten Zielke) believe that IAS 27A should not be endorsed for use in the European Union and therefore dissent from EFRAG's decision to recommend its endorsement. These EFRAG members have reached this conclusion because they believe aspects of IAS 27A do not meet the endorsement criteria. In particular:

Accounting for ownership interest transactions that do not involve a loss of control

1. Under IAS 27A, when a parent entity buys or sells some of its interest in its subsidiary without losing control, that transaction is treated as a transaction between equity holders in their role as equity holders. As a result, no gain or loss is recognised in profit or loss. This accounting in IAS 27A is based on an entity perspective accounting model, in which the non-controlling interest and the parent entity shareholders are treated the same way. However, Mr Michael Starkie and Mr Carsten Zielke believe that the entity perspective accounting model is flawed because the non-controlling interest do not always share in the same risks and benefits as the parent entity shareholders and as a result should not necessarily be treated the same way. The result is that information that is relevant—the gains and losses arising on ownership interest transactions that do not involve a loss of control—is obscured and, as a consequence, is not satisfactorily reported.

2. Mr Michael Starkie and Mr Carsten Zielke believe that the primary objective of financial reporting is to provide information to the shareholders of the parent entity, and in their view whilst the existing mixed entity/parent perspective does that, the entity perspective does not. In their view, it is important that the consequences of changes in ownership interest that affect the owners of the parent entity are reported in the financial statements, but the entity approach does not do that.

3. Mr Michael Starkie and Mr Carsten Zielke also believe that the acquisition of a bigger interest in the subsidiary should result in more net assets (and goodwill) being recognised, and that IAS 27A does not report this relevant information.

Accounting for ownership transactions that involve a loss of control

4. Under IAS 27A, when a parent sells some of its interest in a subsidiary and, as result, loses control of that subsidiary, the former parent recognises a gain or loss not only on the ownership interest disposed of but also on the ownership interest retained. In effect, the retained interest is remeasured at the date control is lost. Mr Michael Starkie and Mr Carsten Zielke believe this is inappropriate accounting and results in the reporting in profit or loss information that is not relevant. In their view, if the retained interest has to be remeasured at the date control is lost—and they are not convinced such a remeasurement is appropriate—any gain or loss should be recognised in equity until such time as it is disposed of.