EFRAG
European Financial Reporting Advisory Group

15 June 2007

IFRS 1 Amendments
Jeff Singleton
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir

Re: Exposure Draft of Proposed Amendments to IFRS 1 *First-Time Adoption of International Financial Reporting Standards: Cost of an Investment in a Subsidiary*

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: Cost of an Investment in a Subsidiary* (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.

The proposal in the ED is to grant some relief from two of the requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* that relate to the first-time implementation of IAS 27 *Consolidated and Separate Financial Statements* on first-time adoption of IFRS.

The first proposed relief relates to IAS 27's requirement that parents shall in their individual financial statements measure their investments in subsidiaries at cost or fair value. There are circumstances in which it can be burdensome to determine the cost amount on transition to IFRS—particularly if under previous GAAP the carrying amount of the subsidiary has been measured in a manner that is not in accordance with the present IAS 27—and EFRAG understands that this is making some companies reluctant to adopt IFRS. EFRAG agrees that there is a need for some sort of relief from this requirement for first-time adopters. However:

- we have some concerns about the actual relief proposed. Two approaches for arriving at deemed cost are proposed and, although we are content for the transition date fair value approach to be one of the approaches allowed, we think the other approach (the transition date net assets approach) is flawed—because it does not consider goodwill—and therefore needs to be amended. We also believe that there are other equally satisfactory approaches that could be used to arrive at deemed cost and we think IFRS 1 should be amended to allow those approaches to be used as well.

- we believe that the types of relief proposed in the ED need to be clarified in certain respects if they are to be applied consistently.

The second proposed relief relates to IAS 27's requirement that, for the purposes of applying the cost method in IAS 27, the parent shall restate the subsidiary's accumulated profits at the acquisition date in accordance with IFRSs. This requirement is also causing problems for parents that have not under previous GAAP been required to distinguish between pre- and post-acquisition profit. Again, EFRAG agrees that there is a need for some sort of relief from this requirement for first-time adopters. However we are concerned that the approach described in B6(a) does not deal satisfactorily with cases where applying the net assets approach proposed in the ED results in a write-down in the carrying amount of the investment on transition simply because goodwill is not considered.

Our detailed comments are set out in the attached appendix to this letter.

If you would like further clarification of the points raised in this letter, Charlotte Norre or I would be happy to discuss them further with you.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

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 the fair value, at that date. Is this appropriate? 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 in accordance with IAS 27.

2 However, we have two concerns about the particular relief proposed in the ED. The ED proposes allowing a parent that is a first-time adopter to use a deemed cost (rather than actual cost). It further proposes allowing a parent to use as deemed cost either the transition date fair value of its investment in the subsidiary or its 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 have no difficulty with the first approach (the transition date fair value approach), but believe that the second approach (the net assets deemed cost approach) is flawed because it does not consider goodwill. This means that it may result in some parents having to write down their investment in a subsidiary on the date of transition to IFRSs solely because of transition to IFRSs and not as a result of impairment of the investment. Such a write down may have adverse taxation or legal implications, including implications for the entity's ability to distribute dividends. It may also mean that the deemed cost would not bear a reasonable resemblance to cost.

We believe this means in some jurisdictions that, if a parent wishes to use a deemed cost, it will have little choice but to use transition date fair value. This can be a very costly and time-consuming measurement to determine and may even be impracticable in some cases. We therefore believe that one or more practical alternatives that do not have adverse implications are needed.

3 We think some sort of net assets deemed cost should be one of those alternatives, although we believe it should be a net assets approach that takes goodwill into account, rather than the approach proposed in the ED. We understand that some constituents argue that it may not always be possible to identify the goodwill of each subsidiary. In particular, in situations where group re-organisations have taken place since the original acquisition, the goodwill that is applicable to each subsidiary may not have been reallocated. However, we believe it is wrong not to allow entities to include goodwill when the information *is* available, and we think that, in many cases at least at the group level, the goodwill amounts will be available for each subsidiary or reorganised sub-group because of the requirements in IFRS 1 for Business Combinations, IAS 36 to test for goodwill impairments or previous GAAP requirements.

4 In addition to the transition date fair value approach described in the ED and the amended net assets deemed cost approach we have described in the preceding paragraph, we think entities should be allowed to use two other methods that we believe are easy to apply and will result in information that is at least as useful as the methods mentioned in the ED.

(a) Previous GAAP equity accounting—In some jurisdictions in Europe the required practice is for parent entities to use equity accounting to account for their subsidiaries in their separate financial statements. (originally this was consistent with the requirements of IAS 27, although equity accounting is of course no longer permitted under IAS 27). As far as we can tell from the Basis for Conclusions, the IASB has not considered the possibility of allowing this previous GAAP equity accounting number to be used as deemed cost. Yet we think an equity accounting number can provide information that is as useful as the two methods proposed in the ED. (We note also that, unlike the proposed net asset approach, the equity method would consider goodwill, as the equity method means that the investment in the subsidiary is initially recognised at cost and the carrying amount is increased or decreased to recognise the parent's share of the profit or loss after the date of acquisition). Allowing the use of previous GAAP equity accounting as deemed cost would also be consistent with the paragraphs in IFRS 1 that already allow the use of values for business combinations that are based on an entity's previous GAAP.

(b) The net carrying amount of the subsidiary (including related goodwill) included in the consolidated IFRS financial statements at the date of the parent's transition to IFRS after adjusting for consolidation and equity accounting adjustment and for the effects of the business combination in which the entity acquired the subsidiary—We note that this amount is already used when accounting under IFRS in the consolidated financial statements and we see no reason why it should not also be allowed as the deemed cost in the parent's financial statements. The information is easily available (because it is already used when preparing the consolidated financial statements) and the resulting number will often be similar to the net asset value approach proposed in the ED except that it considers goodwill.

5 We understand that, when the ED was being developed, the IASB considered the possibility of allowing parents to use previous GAAP cost as deemed cost and that the IASB rejected the option on the grounds that in some situations the cost of an investment in a subsidiary determined in accordance with an entity's previous GAAP cost would bear little resemblance to cost calculated in accordance with IAS 27. This, the IASB concluded, would mean that the approach would provide less useful information than the other two methods (net asset value and fair value) proposed in the ED.

We agree that there are circumstances in which the previous GAAP cost number will bear little resemblance to the IAS 27 cost number. However, we believe that in many more cases—indeed in most cases—the previous GAAP cost number will be based on principles that do not differ significantly from those underlying the IAS 27 number. What concerns us though is it is clear from the responses we have received that commentators believe that, even if their previous GAAP numbers are prepared using principles that are not significantly different from those that underlie IAS 27 cost at initial recognition, they are not able to use those previous GAAP numbers. In our view that would be unfortunate because in an ideal world deemed cost would be based on principles that are not significantly different from IAS 27. We therefore encourage the IASB to make it clear in the revised IFRS 1 that previous GAAP numbers *are* acceptable in such circumstances. We believe it should be underlined that this also includes situations where previous GAAP has not required a parent to recognise distributions received from the pre-acquisition accumulated profits of a subsidiary as a reduction in the cost of the investment as this issue is dealt with separately in paragraph B6 in the ED. We suggest that such a clarification is accompanied by an explanation that, if previous GAAP contains exceptions from the IAS 27 cost-like principles and the company took advantage of those exceptions, the previous GAAP number would not be acceptable. The IFRS could make it clear that that would be the case for example if the company had taken advantage of UK merger relief.

Other comments

Some clarification is needed

6 On a more detailed level, we think that some clarification is needed in respect to paragraph B5(a). In particular, clarification would be helpful as to which IFRS amounts should be used by the parent entity when determining the deemed cost of its investment in the subsidiary in accordance with the ED. Paragraph B5(a) requires that, when using net assets as deemed cost, the deemed cost is to be determined as the parent's 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 believe that clarification is needed because IFRS 1.24 permits a subsidiary that adopts IFRSs *later* than its parent to measure its assets and liabilities at either:

(a) the amounts included in the parent's consolidated financial statements, based on the parent's date of transition to IFRS (excluding any effects arising from consolidation adjustments such as accounting policy adjustments and the business combination in which the parent acquired the subsidiary); or

(b) the carrying amounts required by IFRSs based on the subsidiary's own date of transition to IFRSs.

Because of IFRS 1.24, the carrying amounts that IFRSs would require by the subsidiary entity may depend on:

(a) the date of transition to IFRSs for, respectively, the parent's consolidated financial statements and the subsidiary's financial statements; and

(b) consolidation adjustments such as accounting policy adjustments, in the event that the subsidiary chooses accounting policies that differ from those selected by the parent entity in its consolidated financial statements.

Further, in our view example 9A seems to imply that there is only one set of IFRS numbers that could pertain to the subsidiary entity. However, and as explained above, this is not necessarily always the case. We think it would be helpful if example 9A in the implementation guidance could also clarify this point and illustrate which IFRS numbers should in fact be used i.e. how the choice available in IFRS 1.24 might have an effect, if any, on the “carrying amounts” as described in B5(a).

7 When the parent entity adopts IFRS later than its subsidiary entity, IFRS 1.25 does not permit a choice, and the consolidated financial statements of the parent must measure the net assets of the subsidiary at the same carrying amounts as in the financial statements of the subsidiary, after adjusting for the effects of consolidation procedures and business combinations. We think it would be helpful if paragraph B5(a) of the ED would clarify whether the carrying amounts that IFRS would require, exclude any effects arising from consolidation adjustments such as accounting policy adjustments and the business combination i.e. whether the measurement is determined on a “separate” or a “consolidated” basis.

8 We believe that the above examples in 10 and 11 illustrate that this issue is not as straightforward as it might at first seem and that, as a result, clarification as to what “carrying amounts” mean should be provided in the form of implementation guidance or by expanding the defined terms in Appendix A of IFRS 1.

Investments in associates and jointly controlled entities

9 We believe that the IASB should consider extending the scope of the relief proposed in the ED so that it is also available to a parent’s investments in its associates and jointly controlled entities. We suggest this because it seems logical and because we note that the present exemption for business combinations in IFRS 1.B3 and the guidance in IFRS 1.24 and 25 on the measurement of assets and liabilities of subsidiaries also apply to associates and joint ventures.

Positioning of material

10 Finally, we wonder whether it might be more appropriate to position the proposed amendment to IFRS 1 in the standard section near to the material to which it is closely related (the material in paragraphs 24 and 25 on ‘Assets and liabilities of subsidiaries, associates and joint ventures’) rather than in an Appendix.

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 not?

11 The ED proposes that relief should be granted from the requirement in IFRS 27 that, for the purposes of applying the cost method in IAS 27, the parent shall restate the subsidiary's accumulated profits at the acquisition date in accordance with IFRSs. We agreed that relief from this requirement is needed for first-time adopters.

12 It is proposed in the ED (paragraph B6(a)) that, when a parent takes advantage of one of the reliefs discussed in question 1 when measuring an investment in a subsidiary, that parent shall treat that subsidiary's accumulated profits under IFRSs at the date of transition to IFRSs as the pre-acquisition accumulated profits. The effect of this is to prevent a parent from recognising the subsidiary's post-acquisition but pre-parent's transition to IFRS profits twice—once on restating the investment in the subsidiary to deemed cost (measuring the deemed cost using either the net assets or the fair value of the subsidiary) and again in income (when distributions from the subsidiary were received) (BC8). Although we support the IASB's efforts to avoid double-counting, we are concerned that the approach described in B6(a) does not deal satisfactorily with cases where applying the net assets approach proposed in the ED results in a write-down of the carrying amount of the investment on transition simply because goodwill is not considered. In such cases the parent would recognise a debit because of this write-down and be required to account for that subsidiary's accumulated profits at the date of transition to IFRSs as pre-acquisition accumulated profits. This means that the parent may suffer a double debit when distributions are regarded as a recovery of the investment and recognised as a reduction of the cost of the investment. This issue would be solved if the net asset approach is amended as we have suggested to consider goodwill.

The two alternative methods to deemed cost that we have proposed in paragraph 4 will not require any changes to paragraph B6(a) because both methods take into account the parent's share of the profit or loss at the date of transition to IFRSs. (For that reason, if a parent applies one of these two methods as deemed cost, it should be required, at the date of transition to IFRSs, to treat that subsidiary's accumulated profits under IFRSs as pre-acquisition accumulated profits.)

13 The ED also proposes (in paragraph B6(b)) that a parent that is not taking advantage of the relief discussed in question 1 shall for all other subsidiaries either determine the pre-acquisition accumulated profits of each subsidiary in accordance with IFRSs or treat the pre-acquisition accumulated profits of each

subsidiary under previous GAAP as the pre-acquisition accumulated profits under IFRSs.

(a) We agree that relief should be available to parents that do not need the relief discussed in question 1 but have difficulties determining whether the distributions from a subsidiary that were received by the parent after adopting IFRSs were income or a return of the original investment.

(b) We also agree with the relief proposed. We note that the effect of the relief proposed under paragraph 6B(b)(ii) will sometimes be to allow the entity to treat as income distributions paid out of what could be pre-acquisition under IFRS. That is not ideal, but we accept that such issues can arise when relief of this kind is given.