National Australia Bank

ED 160 sub 9

18 February 2008

Ms Amy Schmidt
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Ms Schmidt

Exposure Draft on the Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate – December 2007

General Comments

We are pleased to respond to your invitation to comment on the above exposure draft.

As a member of the Australian Bankers' Association (ABA), we endorse the proposed amendments and the comments provided in the ABA's comment letter to you dated 24 January 2008. As such, we will focus our response on the critical question to which we have additional specific comments to raise beyond those contained in the ABA comment letter.

Participants in the Australian banking industry, including the National Australia Bank, are keenly interested in the resolution of the current inappropriate accounting requirement under which a new parent would need to record its investment in the existing entity at fair value. We therefore commend the IASB for its efforts to rectify this situation by enabling the use of existing carrying amounts to be adopted in such circumstances. This is entirely consistent with the principle that "nothing has happened" from a substantive point of view through the inter-position of a new parent between the existing entity and its shareholders.

We strongly encourage the IASB to expedite the amendment to IAS 27 regarding new parent formations, but only after adopting certain necessary refinements to the current application criteria. If these changes are not made, then it is highly unlikely that reorganisations within the Australian banking industry could use the new accounting treatment being proposed.

Our detailed comments on the specific question dealing with new parents are detailed below.

Request for comments:

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?

We strongly agree with the general approach taken by this proposal, particularly as it will have the effect of bringing the IFRS accounting treatment in line with the US GAAP treatment. However, we believe that the current wording should be clarified and refined to make it more readily accessible to entities undertaking genuine reorganisations of the type envisaged by the Board in BC22.

We also strongly concur with the view reflected in the Exposure Draft that formations of new parents are not common control transactions by virtue of IFRS 3.11 and accordingly require clarification of accounting treatment through an amendment to IAS 27.

At its essence, the Board's objective is to stipulate that a new parent must record its investment in the existing parent entity using the carrying amount of that entity's net assets when there is no change in the ownership of the Group. We fully support this objective.

However, in order to better achieve this objective and to avoid unnecessary limitations to the application of proposed paragraph 37A, the following crucial matters need to be clarified:

- what is meant by "ownership" (and the associated use of the term "wholly owned subsidiary");
- what is the "effective date"; and
- the application to intermediate holding companies.

We set out below why we believe these clarifications are necessary, and propose recommended approaches to refine the current Exposure Draft wording.

Clarification of Ownership

The Exposure Draft wording has introduced the requirement that the existing parent entity become a "wholly-owned subsidiary" of the new parent, but there is no definition provided either in existing IFRS or in the Exposure Draft for this term. This situation creates the risk of interpretation differences and inconsistent application in practice.

In considering the relevance of this term to the proposed accounting for new parent formations, there are a number of aspects that require further consideration. These relate to the complications that arise when the existing parent has preference shares or other similar securities (such as hybrid securities) on issue, and the extent to which those securities can be transferred to the new parent. We note that most participants in the Australian banking sector would have some form of such securities on issue.

The treatment of such securities is important as, in undertaking a reorganisation under a new parent, the preference or hybrid securities may remain on issue by the existing entity and continue to be held by the existing holders because:

(a) of difficulty for groups to refinance existing preference share issues or similar securities out of the new parent due to the impact of repricing and potentially restrictive covenants on these classes of equity; and

(b) if such securities were to be fully owned by the new parent and replicated by issue out of that new parent, there would be a significant and adverse loss of treatment as regulatory capital for a prudentially regulated group.

Issue 1 - Exclusion of securities with "capped equity claims" from the concept of ownership

The current wording does not take into consideration the situation where there are preference shares or similar classes of securities on issue in the existing entity that have a capped equity claim, and which are not replicated in the new parent.

Securities with capped equity claims, such as preference shares should not be regarded as an "ownership" interest for the purpose of determining the application of the revised accounting treatment. Unlike ordinary shares, which carry the right to vote and to share in the surplus assets of a company upon winding-up, preference shares or similar classes of securities typically carry substantially reduced voting rights and no right to share in the surplus assets of a company upon winding-up beyond the amount of paid-up capital on the security.

We believe that where a class of security with a capped equity claim exists both before and after the restructure, and there are no changes to the legal rights and benefits attaching to such securities as a result of the reorganisation, then it should not matter, for accounting purposes, whether those securities are wholly owned by the new parent, or remain owned by the existing security-holders. This distinction is particularly important in a highly regulated environment, such as banking, as there may be prudential regulatory reasons for maintaining the equity represented by the securities with capped equity claims in the existing entity, rather than replicating it in the new parent.

Issue 2 - Definition of "wholly-owned subsidiary"

Proposed IAS 27 paragraph 37A indicates that the existing entity must become a "wholly-owned subsidiary" of the new parent. Based on the proposed amendment, the Basis for Conclusion and other IAS standards, the definition of "wholly-owned" is unclear when preference shares or similar securities are involved.

From an accounting perspective, it could be argued that (especially as the proposed amendment is to that Standard) the meaning of "wholly-owned" would be determined by reference to IAS 27, which is based on the concept of control,. IAS 27 paragraph 13 indicates that control is presumed to exist when the parent owns more than half of the voting power of an entity. This would suggest that, adopting a similar approach to that emphasised in IAS 27, determining whether an entity is wholly-owned should focus on voting rights and power - that is, it should be based on who owns all of the equity share capital that normally carries ordinary voting rights.

In addition, common control transaction accounting allows application to entities that are 50% or greater owned, not just wholly-owned. In contrast, the revised IAS 1 defines owners as holders of instruments classified as equity. Potentially, this would mean that to be a "wholly-owned subsidiary" this would require all ordinary share capital **and** preference share capital to be owned (or controlled) by the new parent.

Given the lack of a clear definition of "wholly-owned subsidiary" for accounting purposes, some guidance may be sought by reference to the definition of such terms in the relevant jurisdiction's companies code / securities legislation. However, this definition too varies from jurisdiction to jurisdiction. For example:

(a) under Australian law, the Corporations Act 2001 defines "wholly-owned subsidiary" by reference to the concept of "members" of a company, and. Therefore, under Australian law a holder of a share, including a preference share, is a member of the relevant company. On that basis, if preference shares on issue by the existing entity remained held by existing holders (and were therefore not all held or controlled by the new parent) then the existing entity **would not** be a wholly-owned subsidiary of the new parent, with the consequence that the revised accounting treatment would not apply. We understand that the position under the UK Companies Act is broadly similar to that under Australian law; however, in contrast

(b) under the US Securities Act 1958 and Securities and Exchange Act 1934, "wholly-owned subsidiary" is defined by reference to a parent owning substantially all of the outstanding voting securities of the subsidiary. A "voting security" is a security whose holders have a present entitlement to vote on the election of directors. Preference shares would normally not carry such a voting entitlement. Accordingly, under these US Acts, preference shares would not be voting shares and therefore the existing entity **would** be a wholly-owned subsidiary of the new parent.

Accordingly, we consider that the use of the term "wholly owned subsidiary" creates uncertainty and the potential for the different application of the revised accounting treatment between different jurisdictions.

Recommendation

We recommend that Board revise the references to "owners" and "relative ownership interests" in proposed paragraph 37A to address the issues created by preference shares and similar securities described above.

We further propose that the term "wholly-owned subsidiary" becomes superfluous and therefore should be removed altogether from proposed IAS 27 paragraph 37A and Basis for Conclusion paragraph BC21. The existing requirement in proposed paragraph 37A to not change the equity or assets and liabilities of the group will be sufficient to limit the application of the proposed amendment.

Clarification of Effective Date

Proposed IAS 27 paragraph 37A indicates that "In applying paragraph 37(a) to *such formations*, the new parent shall measure the cost of its investment in the existing entity using the carrying

amounts of the equity, assets and liabilities in the separate financial statements of the existing entity at the *date of the formation*." (emphasis added)

The term "formation" is not entirely clear. It could be interpreted as referring to the reorganisation of the operating structure of the existing entity (which would be consistent with the first sentence of the paragraph). Or it could be interpreted as referring to the date of formation of the new parent (which would be more consistent with the normal use of the word). If the latter interpretation was taken, this would appear to suggest that the cost is measured based on the date that the legal entity which will become the new parent is formed, rather than the date that the reorganisation occurs and that legal entity does in fact become the new parent. Due to legal and taxation aspects, it is likely that the entity that ultimately becomes the new parent would initially be formed prior to the reorganization as a subsidiary of the existing parent. It is also likely that this would occur at a time that is significantly before the date of reorganisation. Accordingly, using the cost at the date of formation of the entity that ultimately becomes the new parent could result in a significantly different result to that determined using the cost at the date of reorganisation.

Recommendation

We believe that the wording should be revised such that the use of the word "formation" is replaced with "reorganisation".

Application to Intermediate Holding Companies

A question of interpretation has been raised in relation to the application of proposed paragraph 37A when intermediate holding companies are inserted within a group.

Paragraph 37A indicates that an entity may 'reorganise its operating structure', and BC 22 indicates that:

(i) it 'involves existing entity and its shareholders agreeing to create a new parent between them', and
(ii) 'in contrast, most transactions... are initiated by a parent over an entity that will be positioned below it...'.

There seems to be ambiguities in the wording as 'reorganise its operating structure' implies that the accounting would apply to the wider reorganisation rather than the insertion of a new parent. BC 22 may also allow the application to the formation of an intermediate holding company. Unless the principle is equally applicable to the insertion of an interposed new parent, this would recreate the issue that the proposed amendment is trying to resolve in the separate financial statements of that interposed parent.

To express this in a slightly different way, take the example where two new holding companies (one an ultimate holding company, the other an intermediate holding company) are interposed vertically between an existing entity and its shareholders, rather than interposing one new holding company. Assuming that all the other criteria of paragraph 37A are met, there does not seem to be any substantive difference between either scenario.

Recommendation

We recommend that the Board clarifies that the proposed revised accounting treatment should apply to the establishment of any new parent entity which is interposed between existing shareholders (including other companies in a group) and the existing entity.

Comments on Fair Value Approach for New Parent Formations

As noted in the Basis for Conclusion, some would account for new parent formations by recording the cost of the investment in the existing parent entity in the new parent's accounts at the fair value of the shares issued. We are against this position, as we believe that the accounting principle should be that where no acquisition has occurred, there should be no recognition of internally generated goodwill or revaluation of equity. This could even lead to distributions to equity holders from such fair value increments despite no external transaction having occurred. These fair value increments reflect internally generated intangibles, goodwill and other measurement differences that are precluded from recognition in the existing parent and group accounts by IFRS accounting standards.

In addition, as you may be aware, a legal solution was considered in 2007 to solve this issue in the Australian context. However it was decided between the Australian Government and both the international and Australian accounting standards bodies that the solution had to be in accordance with International Financial Reporting Standards such that full compliance with IFRS could be asserted.

The implications of adopting the fair value approach as it relates to the insertion of a new parent is that any significant or prolonged subsequent reductions in fair value would cause the new parent to test its investments for impairment. The recognition of any losses would then restrict the amount of profits that the new parent could pay as dividends to its shareholders. The approach of the proposed amendment significantly reduces the impact of these issues.

Please contact Ian Coulson on +61 3 8641 5789 or ian_coulson@national.com.au if you need any further clarification.

Yours sincerely

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cc. Mr David Boymal
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