AUSTRALIAN BANKERS' ASSOCIATION INC.

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Amy Schmidt
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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Ms Schmidt,

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

We are pleased to submit this comment letter in response to your Invitation to Comment on the above exposure draft of proposed amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards and IAS 27 Consolidated and Separate Financial Statements.

In Appendix A to this letter we have responded to all of the questions raised by the IASB. However, we wish to emphasise the comments on question 5 in relation to the formation of a new parent. This proposal is particularly relevant to the ABA's constituents who have, or intend to undertake, a reorganisation by inserting a Non-Operating Holding Company (NOHC) between the existing parent entity and its shareholders without affecting the legal rights or economic benefits held by any non-controlling interests. For your information only, we have addressed additional questions asked by the Australian Accounting Standard Board and include our answers as Appendix B.

We strongly agree with the approach taken in this proposal but have concerns with the amendment as it is currently drafted. We are concerned that the current drafting raises issues that are sufficiently serious as to negate the purpose of the reorganisation proposals (and therefore would not change the accounting treatment currently adopted) insofar as they apply to Australian banks.

Please contact Nicholas Hossack on +61 2 8298 0408 if you have any questions or comments.

We thank the IASB for the opportunity to comment on this proposal.

Yours sincerely

David Bell

David Bell

Cc: The Chairman, Australian Accounting Standards Board

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Appendix A - Exposure Draft on the Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate

We are pleased to respond to your Invitation to Comment on the above exposure draft of proposed amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards and IAS 27 Consolidated and Separate Financial Statements.

1. Introductory comments

About the Australian Bankers Association

The Australian Bankers Association ("ABA") works with its 25 member banks to provide analysis, advice and advocacy and contributes to the development of public policy on banking and other financial services.

With the active participation of the member banks, the ABA works to foster an environment in which financial services are valued and can prosper. In communicating the industry's views, the ABA works with Governments, the regulators, other industry associations, the community, community groups and the media.

The ABA's interest in the Exposure Draft

The public policy of the Australian Federal Government is to encourage Australian banks, life insurance companies and general insurers to adopt a Non-Operating Holding Company ("NOHC") legal structure, as is common practice in the financial services industries of the major developed countries. During the first half of 2007, the Government enacted new financial sector legislation that had the effect of removing the remaining disincentives that arose from sources it was able to influence (in areas such as taxation rollover relief and corporate law restrictions on distributions to shareholders) and that previously prevented these Australian financial institutions moving to a NOHC structure.

Notwithstanding these changes, the effect of the current application of IAS 27 continues to be a disincentive to NOHC implementation. The ABA agrees with the current interpretation applied by some as described in BC 21 of the ED when applying IAS27 paragraph 37(a) to new parent formations.

The ABA and its member banks agree with the Board's decision to amend IAS 27. In our opinion BC 22 of the ED, which reflects the Board's view, appropriately explains the Board's conclusions.

General comments

Whilst the ABA agrees with both the analysis of the problem and the Board's view on the issue, we have important concerns about the drafting of proposed paragraph 37A of IAS 27 for new parent formations. It is not a necessary

consequence of the conditions in BC 22 that new parent formations result in the existing entity becoming a wholly-owned subsidiary of the new parent.

Our responses to the specific questions outlined in the exposure draft are detailed below.

2. Request for comments

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

We agree with the two deemed cost options as proposed in the exposure draft. Although many of the ABA's constituents are already applying IFRS, there may still be circumstances where IFRS 1 First-time Adoption of International Financial Reporting Standards will be relevant.

For example, if an Australian bank owns a group of companies in a jurisdiction not currently subject to IFRS and that jurisdiction moves to adopt IFRS, then this change will need to be applied to that group of entities. When the investee is preparing its first IFRS financial statements, it will be practically advantageous for that entity to be able to use, in its separate financial statements, either cost or deemed cost when applying IAS 27.37(a) for the first time.

We question whether deemed cost should also be able to be determined using the "net asset deemed cost" approach. Under this approach, deemed cost is determined as the parent's interest in the carrying amount of the subsidiary's assets less liabilities, using the carrying amount that IFRSs would require in the subsidiary's statement of financial position as at the date of transition to IFRS. While comment has been made that, in many instances, the "net asset deemed cost" approach and the "previous GAAP carrying amount" may not represent "cost", and could be viewed as resulting in numbers that are equally arbitrary (as discussed in BC12), the "net asset deemed cost approach" could be argued to result in a more relevant number than a previous GAAP carrying amount. Accordingly, the net asset deemed cost approach should not be precluded from being used as a deemed cost.

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?

We agree with the proposal to use the deemed cost option for investments in jointly controlled entities and associates. The ability to use either fair value or previous GAAP carrying amount resolves the difficulty of obtaining the needed information and appropriately considers different national GAAP measurements having to be applied by companies that have been operating for many years (and consequently their accounting records not holding information needed to cope with a change in measurement). This solution is particularly relevant for

investments in both associates and joint ventures where it may be potentially difficult to determine fair value reliably.

Questions 3 — Do you agree with the proposal to delete the definition of the cost method from IAS 27? If not, why?

We agree that the deletion of the definition of the cost method is an appropriate way to remove the difficult judgement needed in distinguishing between dividends from the pre-acquisition and post-acquisition retained earnings and reserves.

Whilst the pre/post-acquisition concept has stood the accounting community in good stead over a long period of time, the removal of this concept will also resolve some issues that arise in relation to internal restructures. One particular concern of our members is where post-acquisition retained earnings and reserves lose that status when the entity is acquired in a common control business combination and a carry-over basis accounting is elected for that transaction. The new parent within the group reorganisation that now holds the subsidiary treats subsequent dividends received from the subsidiary's pre-existing retained earnings as 'pre-acquisition'. Effectively, the new parent cannot pay a dividend in respect of dividends received from the subsidiary's pre-existing retained earnings (ie a dividend trap within the group). From the group's perspective, this has the effect of reducing amounts distributable to the ultimate external shareholders even though the group's position has not changed. This interpretation has also been applied to what were the post-acquisition retained earnings and reserves of a holding company when a new parent is formed above it. This proposal addresses this problem.

In the event that this proposal is not pursued, it would be useful for the purposes of the new parent formation proposals for the Board to observe that the reorganisation does not change the pre- and post-acquisition status of group retained earnings and other distributable reserves.

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

Conceptually, we agree with the approach taken in this proposal but have some concerns with the amendment as it currently stands. Though not defined very clearly in the supporting material, we have assumed that a dividend is only meant to refer to a distribution of retained earnings and other distributable reserves, rather than a capital redemption/cancellation. Our comments relate to the "dividends recognised as income" and "impairment testing" concepts, and are discussed further below:

Dividends recognised as income

We agree with the removal of the pre-acquisition/post-acquisition distinction such that all distributions from retained earnings of the investee should be recognised as income by the investor. However, we believe that it is necessary to distinguish between a dividend paid out of retained earnings and a return of capital (eg redemption / cancellation) by an investee sourced from share capital.

Under IAS 18 *Revenue*, paragraph 5(c) states "The use by others of entity assets gives rise to revenue in the form of:

> (c) dividends – distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital."

As a return of capital can lead to the use of the entity's assets by the parent, this could be interpreted as meaning that all amounts received from a subsidiary would be treated as income irrespective of whether it was sourced from the investee's share capital or retained earnings.

As noted above, we agree that all distributions received from an investee's retained earnings and other distributable reserves should be recognised as income. However, this amendment should not change the accounting for a "return of share capital" transaction such that amounts received from an investee's share capital account is treated in the hands of the investor as a return of investment (ie reduction in the carrying value of the investment) rather than a dividend.

Impairment testing

We believe that the costs of the proposal to test the investment for impairment each time a subsidiary pays a dividend would exceed the benefits of such an approach. Particularly, as in some circumstances the quantity of the dividend paid will be such that it is clearly obvious that no impairment has arisen.

Australia has adopted IFRS for all entities, and not just listed entities. For certain entities, dividends are paid on a regular basis for regulatory and capital management reasons and these dividends need to flow through the Group to the ultimate parent. The proposal would require multiple impairment tests to be undertaken as dividends are paid up through the Group, and would add substantially to the administrative burden.

A more appropriate approach would be to consider a significant cumulative amount of dividends paid during a reporting period relative to either the current period profit or opening retained earnings and reserves, as an indicator of impairment under IAS 36 *Impairment of Assets*, paragraph 9. An appropriately worded impairment indicator would need to be drafted to reflect this.

We also query whether any impairment recognised as a result of the dividend impairment test can be reversed. IAS 36 states that an indication that an asset may be impaired is "the carrying amount of the net assets of the entity is more than its market capitalisation" (IAS 36.12(d)). There is no similar indicator in IAS

36.111 that operates in the opposite direction to permit a reversal of a previous impairment loss. Therefore, there could be some uncertainty as to whether an impairment recognised as a result of a dividend payment can subsequently be reversed because of similarities with the situation in the abovementioned paragraphs.

Finally, if an impairment occurred, and the investment is written down to its recoverable amount, then entities should be able to credit part of the dividend against the investment (to the extent of the write-down), and any remaining amount can be regarded as income. This treatment would represent the substance of the transaction.

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?

As indicated above, we strongly agree with the approach taken in this proposal but have some issues with the amendment as it is currently worded. As noted above, this proposal is particularly relevant for the ABA's constituents who have, or intend to undertake, a reorganisation by inserting a NOHC between the existing parent entity and its shareholders.

Under the current interpretation applied by some, the cost of the investment in the existing parent entity is recorded in the NOHC's accounts at the fair value of the shares issued. Any significant or prolonged subsequent reductions in fair value would trigger the requirement by the NOHC to test for impairment losses, and the recognition of any losses would then restrict the amount of profits that the NOHC could pay as dividends to its shareholders. The approach of the proposed amendment reduces the impact of these issues.

Our issues with the current drafting of the proposed amendment reflect areas that require important clarification otherwise there may be significant application problems in practice. These relate to:

- Inclusion of the "wholly-owned subsidiary" term in the description of a new parent reorganisation
- Clarification of the tests for a new parent formation, and
- Reference to no change in "assets and liabilities" as part of the test.

Wholly-owned subsidiary

We believe that the current drafting does not address the situation where there is a class of equity in the existing entity that has a capped equity claim, such as preference shares, which is not replicated in the NOHC. Where a particular class of equity has a capped equity claim that exists both before and after the restructure, and its legal rights or economic benefits are not affected by the reorganisation, we think it should not matter, for accounting purposes, whether that equity claim is transferred to the new parent or remains with the existing

entity. The fact that capped equity claims have not been replicated in the new parent reflects impositions from the regulatory environment of the banking industry, particularly in Australia. Whilst there may be matters of legal equity or shareholder approval involved, these are not accounting matters. The important aspect is that the respective claims (ie legal rights and economic benefits) of the various classes of equity are unchanged between themselves and in aggregate.

Accordingly, we strongly recommend that the reference to "wholly-owned subsidiary" be removed from proposed IAS 27 paragraph 37A and Basis for Conclusion paragraph BC21. If this change is not made, then very few if any reorganisations within the Australian banking industry are likely to avail themselves of this new accounting treatment.

Also, it is recommended that a clarification be included such that "owners" relate to ordinary shareholders (those with full voting rights and ranking last in liquidation) and potential ordinary shareholders of the parent, rather than also covering a class of equity that has a capped equity claim.

We understand the reason for the "relative interests" criteria is to stop a situation in which one group of shareholders benefits at the expense of another without the total equity on issue changing. There would be no breach of this objective when the interests of the class of equity that has a capped equity claim have the same claim (ie legal rights and economic benefits) before and after the restructure and there has been no alteration of the legal rights or economic interests within the class of ordinary shareholders.

New parent formation

There is an apparent inconsistency between proposed IAS 27 paragraph 37A and Basis for Conclusion paragraph BC22 in relation to the manner of formation.

Paragraph 37A indicates that "the new parent is formed in a manner that does not change the relative ownership interests of the owners of the existing entity or the equity, assets and liabilities of the group." This suggests that one of two tests must be met.

However, paragraph BC22 indicates that "The equity, assets and liabilities of the group do not change as a result of the reorganisation. In addition, the relative ownership interests of the owners of the existing entity do not change." This suggests that both tests must be met in order to meet the requirement.

We believe that the intent of these paragraphs should be clarified.

Equity, assets and liabilities

Both proposed IAS 27 paragraph 37A and Basis for Conclusion paragraph BC22 refer to the "equity, assets and liabilities" of the group. It would be clearer to specify "equity, or assets and liabilities" to remove confusion as to how to measure the cost of the investment.

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

We strongly disagree with the proposal for prospective application. Given the implications for impairment and associated dividend traps for new parent transactions undertaken at fair value in the past, we believe that a permissive retrospective approach (discussed further below) would be preferable.

There is at least one situation in Australia of which we are aware where an entity has very recently undertaken such a reorganisation, and would like to apply this accounting treatment.

A permissive retrospective approach would follow the model included in IFRS 1 Appendix B, Business combinations, paragraph B1. Under this approach the entity may elect to apply the amendment retrospectively to past transactions (transactions that occurred before the application date of this amendment). However, from the date that the entity elects to apply this amendment, it shall apply its requirements to all later transactions.

Appendix B - AASB specific matters for comment

In addition, the AASB would value comments on:

(a) any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(i) not-for-profit entities;

(ii) public sector entities;

The main regulatory issues are:

- New parent formation – the public policy of the Australian Federal Government is to encourage Australian banks, life insurance companies and general insurers to adopt a NOHC legal structure, as is common practice in the financial services industries of the major developed countries. During the first half of 2007, the Government enacted new financial sector legislation removing most of the remaining disincentives (in areas such as taxation rollover relief and profit distributions to shareholders) that had prevented these Australian financial institutions from moving to a NOHC structure.
- Dividends as income – this brings in to question the application of the 'dividends from profit' rule under s.254T of the Australian Corporations Act in the IFRS environment. The Government has provided a limited circumstances exemption to those financial institutions that receive individual approval from the Treasurer as part of the new legislation noted above. While this had legal and tax implications, rather than accounting, it does raise the question as to the definition of profit for the purposes of s.254T. We believe it is time for the Australian Government to seriously consider changes to the Corporations Act so as to rely on a solvency test in order for a company to pay distributions.
- Deemed cost – none readily apparent.

(b) whether, overall, the proposals would result in financial reports that would be useful to users; and

Overall, this proposal will result in financial reports that are useful to users in that the proposed accounting:

- New parent formation – reflects the fact that nothing of economic substance has happened within the group. There have been no changes to shareholders' rights, or the net assets of the group. The change was merely one of form to enable isolation of risks and more targeted regulation. Accordingly, the accounting should reflect that there has been

no change (ie there should not be a step up in value, effectively by revaluing equity) simply by interposing a new holding company.

- Dividends as income – this is particularly relevant with respect to the formation of a new parent. Pre-existing retained earnings of the subsidiaries will not now need to be quarantined under these proposals, thereby allowing dividends to be paid to the new parent (that will ultimately be paid to its shareholders) to be treated as income, and not as a reduction of the investment's carrying value. This has the effect of keeping the ultimate shareholders in the same economic position as prior to the reorganisation. More generally, it addresses the issue of maintaining different accounting records in relation to the pre-/post-acquisition distinction in companies that have been in existence for significant periods of time.

- Deemed cost – limited application to Australia, but will be relevant in certain circumstances

(c) whether the proposals are in the best interests of the Australian economy.

Refer comments above. In addition, the proposed changes:

- Provide a more "readily understandable" and "intuitive" answer to the less well informed investor;

- Assists with avoiding untoward results; and

- Helps to reduce costs of compliance.