

Deloitte Touche Tohmatsu
ABN 74 490 121 060

Grosvenor Place
225 George Street
Sydney NSW 2000
PO Box N250 Grosvenor Place
Sydney NSW 1217 Australia

DX 10307SSE
Tel: +61 (0) 2 9322 7000
Fax: +61 (0) 2 9322 7001
www.deloitte.com.au

Mr David Boymal
The Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS STREET WEST VIC 8007

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Our Ref: MP:FB

Dear David

Exposure Draft ED 160 Exposure Draft of Proposed Amendments to AASB 1 'First-time Adoption of Australian Equivalents to International Financial Reporting Standards' and AASB 127 'Consolidated and Separate Financial Statements - Cost of an Investment in a Subsidiary Jointly Controlled Entity or Associate'

Thank you for the opportunity to comment on the Australian Accounting Standards Board (AASB) Exposure Draft ED 160 *Exposure Draft of Proposed Amendments to AASB 1 'First-time Adoption of Australian Equivalents to International Financial Reporting Standards' and AASB 127 'Consolidated and Separate Financial Statements - Cost of an Investment in a Subsidiary Jointly Controlled Entity or Associate'* (ED 160).

This letter sets out our main comments on ED 160. Our responses to the specific matters for comment raised by the AASB are contained in Appendix A. Our responses to the specific questions raised by the IASB are set out in the Appendix B, together with some additional detailed comments.

We strongly support the proposals in ED 160 in relation to deemed cost, in particular the permitted use of previous GAAP carrying amount which we argued for in our response to ED 152 *Proposed Amendments to AASB 1 First-time Adoption of Australian Equivalents to International Financial Reporting Standards* (ED 152).

We also support the proposals to amend AASB 127/IAS 27 by deleting the definition of the cost method. However, we are concerned that the requirement for mandatory impairment testing when a dividend has been received from a subsidiary, associate or jointly controlled entity in the period will impose an onerous burden on many companies when it is clear there is no impairment.

We strongly disagree with the proposed amendment to IAS 27 relating to the formation of a new parent. We believe that the proposed amendment is not so much the granting of an 'exemption' as limiting the accounting policy choices in relation to the specific category of transactions with which it deals. In addition, the proposed amendment may have significant adverse legal and regulatory impacts in some jurisdictions. Accordingly, we recommend that this proposed amendment to IAS 27 not be implemented at this time and instead the issues should be debated more fully in the context of the IASB's project on accounting for common control transactions.

The context of our Australian submission

Due to the later IASB submission deadline in relation to its equivalent exposure draft, the global firm of Deloitte Touche Tohmatsu has not finalised its views in relation to the matters raised in the IASB's exposure draft. Furthermore, in this letter we have highlighted issues and concerns in the Australian context that may not have the same degree of relevance internationally or which may not be considered of sufficient significance to warrant separate comment by the global firm of Deloitte in its submission. Therefore, the views presented in this document in relation to the IASB's exposure draft should be read in this context and may not necessarily represent the view of the global firm of Deloitte.

If you have any questions concerning our comments, please contact Melissa Sim on (02) 9322 7934.

Yours sincerely



Melissa Sim
Partner
Deloitte Touche Tohmatsu

APPENDIX A – SPECIFIC MATTERS FOR COMMENT – AASB

- (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 amendments do not result in the best outcome in accounting for restructurings

As noted in the covering letter and our response to question 5 in Appendix B, we do not support the proposed amendment to AASB 127/IAS 27 in relation to the determination of the cost of an investment in an existing entity when a new parent entity is introduced into the structure.

There is a lot of uncertainty in the Australian context as to how to account for these types of transactions. To this end, we believe it would be helpful if the IASB could explicitly acknowledge (perhaps most easily in the basis of conclusions) that transactions of this nature do not *require* the use of fair value to recognise the investment in the existing entity in the separate financial statements of the newly incorporated parent and that the IASB is considering this matter as part of its project on common control.

Impacts on other pronouncements

We also note that there may be consequential amendments required to ‘domestic’ pronouncements in the event that the proposals in ED 160 proceed. Although the proposed amendments in ED 160 are focussed on ‘dividends’, it is likely that all types of ‘distributions’, including so-called ‘accounting distributions’ would be treated in the same manner.

For example, the concept of ‘accounting distributions’ arises in Interpretation 1052 *Tax Consolidation Accounting*, which is cross referenced to the requirements of AASB 127 and AASB 118 *Revenue*. Under Interpretation 1052, it is common to account for ‘distributions’ arising under the Interpretation as reductions in the carrying amount of the direct or indirect investment in the associated investment, although there is no universally accepted approach as to when such distributions are considered ‘returns of capital’ or ‘returns on capital’. Accordingly, the AASB will need to consider the impacts on Interpretation 1052 and other pronouncements if the proposals in ED 160 proceed.

The need for consequential amendments to ‘domestic’ pronouncements arising from IASB developments also highlights the difficulties that can be encountered where the AASB makes these types of pronouncements in relation to the for-profit sector. We continue to hold our view that such pronouncements should *not* be made for the for-profit sector and should instead be limited to the not-for-profit and public sectors where it is considered absolutely necessary to do so. Accordingly, we recommend that the AASB consider withdrawing all domestic Interpretations that apply to for-profit entities) as soon as possible, and in any event, no later than as part of the ‘next wave’ of IFRS transition applying from 2009-2010.

Not-for-profit and public sector entities

We are not aware of any specific or unintended consequences of the proposals in the not-for-profit and public sectors. However, we recommend that the AASB consider the impact of the proposals in its current reviews of accounting approaches in these sectors.

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

Our comments on this question are covered elsewhere in this letter.

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

Notwithstanding our reservations noted elsewhere in this letter, in the event that the IASB proceeds with the amendments proposed in ED 160, we believe that it is in the best interests of the Australian economy to issue equivalent amendments to Australian Accounting Standard to ensure full convergence with IFRS.

In order to ensure that the maximum benefits of the convergence process are obtained, there must be no change made by the AASB to the IASB amendments when issuing an Australian Standard, other than any amendments applicable to not-for-profit and public-sector entities that are considered absolutely necessary.

APPENDIX B – RESPONSE TO IASB INVITATION TO COMMENT

Question 1 - Deemed cost

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

We agree with the proposal. In our response to ED 152 *Proposed Amendments to AASB 1 First-time Adoption of Australian Equivalents to International Financial Reporting Standards* (ED 152), we suggested that a simple exemption based on previous GAAP carrying amount should be considered. We are pleased that this suggestion has been taken up in ED 160 as we believe that it will make it easier for companies to adopt IFRSs in their separate financial statements.

Question 2 - Change in scope

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

We agree with the proposal which is consistent with our response to ED 152.

Question 3 - Cost method

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

We agree with the deletion of the definition of the cost method.

We agree with the principle that the receipt of a distribution which is in the nature of a return of capital should be deducted from the cost of investment. This is, however, an economic concept which should not necessarily be influenced by the accounting framework adopted by the parent or the subsidiary. The existing approach raises many issues of interpretation which might need to be addressed if it were to be retained. We therefore welcome the proposed change as a pragmatic solution to this issue.

Question 4 - Cost method

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?

We agree that dividends received should be treated as income. We also agree that that a simple and straightforward way to determine whether this is so is to consider whether the investment has become impaired as a result of the dividend.

However, we are concerned that the proposed amendments to AASB 127/IAS 27 and AASB 136/IAS 36 will have the effect of requiring an impairment test of the investment to be carried out in any reporting period in which a dividend is received. In many cases it will be clear that the investment is not impaired as a result of the dividend. Imposition of a mandatory impairment test would be seen as an onerous new burden on companies.

It is arguable that no explicit requirement for impairment testing is required. The receipt of a large dividend which is out of line with current performance might be seen as an indication of impairment in accordance with paragraph 9 of AASB 136/IAS 36. This would leave room for judgement but require impairment testing in those cases where it is appropriate.

However, we believe that the concerns expressed in paragraph BC 20 of ED 160, could be addressed without imposing an onerous burden on companies. We propose that instead of inserting the requirement into paragraph 10 of AASB 136/IAS 36, the receipt of dividends from subsidiaries, associates and jointly controlled entities should be included in the list of indications of impairment in paragraph 12 of AASB 136/IAS 36. This would permit the application of the concept of materiality to whether the recoverable amount of an asset needs to be estimated as discussed in paragraph 15 of AASB 136/IAS 36.

If the Board concludes that an explicit requirement for impairment testing in paragraph 10 of AASB 136/IAS 36 is necessary, that requirement should not apply to all dividends. It is, however, difficult to define the type of dividends which should result in impairment testing. Any link to reported profits suffers from the same shortcomings as the existing approach in AASB 127/IAS 27.

An additional or alternative approach could also be to introduce an explicit 'short-cut' into AASB 136/IAS 36 which deals with the determination of the recoverable amount of investments in subsidiaries, associates and jointly-controlled entities, in a manner similar to those already implemented for goodwill and intangibles with indefinite lives in paragraphs 15 and 99 of that Standard. These 'short-cut' methods could focus on matters such as:

- whether the recognised consolidated net assets of the subsidiary, associate or jointly-controlled entity substantially exceed the carrying amount of the investment
- the lack of any indication of, or actual, impairment of the investee's individual assets or cash-generating units
- the existence of detailed recoverable amount calculations in previous periods that showed that the recoverable amount of the investment substantially exceeded the carrying amount of the investment, there was no indication that that difference has been eliminated and distributions received during the period were significantly less than the difference.

Including such a 'short-cut' would eliminate any uncertainty as to the application of paragraph 23 of AASB 136/IAS 36 in the circumstances where a 'mandatory' impairment test was required (or an indication of impairment existed in the event our recommendation above is implemented).

Question 5 - Formation of a new parent

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

We do not recommend that the IASB proceed with the amendment.

We strongly disagree with this proposed amendment to AASB 127/IAS 27 at this time and believe that the issues should be debated more fully in the context of the project on accounting for common control transactions.

We are aware of a divergence in interpretation as to whether paragraph 37(a) of IAS 27 requires the new parent to measure its legal investment in the existing entity at the fair value of the existing entity at the date of acquisition. In some jurisdictions, including Australia, this treatment may cause legal and regulatory issues, for example by 'trapping' the undistributed profits of the existing group. We also understand that it is these concerns that have led to the

proposals in the exposure draft, including in relation to transactions involving the creation of new 'non-operating holding companies' (NOHCs) by Australian authorised deposit-taking institutions (ADIs). Whilst the *Financial Sector Legislation Amendment (Restructures) Act 2007* is partially designed to address this issue for ADIs, the same issue arises in many other industries, most commonly in relation to the legal restructuring of a group in preparation for an initial public offering¹.

Furthermore, the alternative treatment proposed in the exposure draft will also create significant difficulties in some jurisdictions. For example, it may be necessary to recognise the share issue at fair value for legal reasons. Where the investment is recognised at a lower amount based on the carrying values in the existing entity, this may result in a large debit balance in equity and the entity's net assets will be less than its share capital. This has significant legal and regulatory implications in some jurisdictions, including the European Union.

Many entities do not currently account for investments in the separate financial statements of the NOHC at fair value on the basis of one or more of the following arguments (amongst others):

- the transaction is a 'non-transaction' or lacks commercial substance as defined in AASB 116/IAS 16 *Property, Plant and Equipment*
- the transaction is a common control transaction because in substance it is akin to the existing parent incorporating a new subsidiary
- the recognition of the investment at fair value produces an outcome that is tantamount to the revaluation of internally generated goodwill and other intangibles, or the pro-forma adoption of the revaluation method of accounting for tangible and intangible assets
- the transaction should be accounted for in a manner akin to a 'reverse acquisition' under AASB 3/IFRS 3 *Business Combinations* and this leads to the conclusion that some measure of 'cost' should be used to measure the investment.

We are aware of numerous approaches being adopted in practice where a NOHC is created, including measuring the investment in the existing company on the basis of amounts such as the following:

- the aggregate consolidated net assets of the existing entity
- the aggregate net assets (equity) in the separate financial statements of the existing entity
- a measure of 'contributed capital' as recognised in the separate financial statements of the parent entity.

¹ We note that the proposed amendments in ED 160 to the recognition of distributions does not fully address this issue. For example, if the investment in the existing entity is recognised at fair value and a significant distribution is paid, it is likely that an impairment loss would be recognised, meaning that there would not be profits available from which a distribution could be paid to the shareholders by the new parent entity. If however, the investment in the existing entity was recognised on a measure of 'cost', an impairment may not be recognised and the distribution could be paid to the shareholders of the new parent.

In our view, the imposition of a NOHC (or other new parent entity) does not trigger the mandatory recognition of the investment in the existing parent at fair value in the NOHC's separate financial statements, although this may be one alternative approach. We believe that there are many alternative methods available for accounting for the investment in these circumstances.

Therefore, in our view, the proposed amendments to AASB 127/IAS 27 have the effect of eliminating existing options from IFRS, rather than granting an exemption from a requirement to measure such investments at fair value as is inferred by ED 160. Because many view these types of transactions to be common control transactions, we are concerned that the proposed amendment to AASB 127/IAS 27 could be considered to be authoritative guidance on how to account for a broader range of common control transactions through the operation of the hierarchy in AASB 108/IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Accordingly, we suggest that the AASB recommend to the IASB that:

- it does not proceed with these amendments at this time
- these issues would be better addressed through the IASB's project on common control transactions.

In addition, it would be helpful if the IASB could explicitly acknowledge that transactions of this nature do not *require* the use of fair value to recognise the investment in the existing entity in the separate financial statements of the newly incorporated parent and that the IASB is considering this matter as part of its project on common control. This action, perhaps best achieved by making a comment to this effect in the basis for conclusions, would remove the uncertainty that current exists as to the nature of these types of transactions.

Additional comments in the event that the IASB decides to proceed with the amendment

If the Board decides to go ahead with the proposed amendment, we believe that it should be in the form of an optional 'exemption' rather than as a mandatory requirement.

We also note that the proposed 'exemption' is limited to situations where the existing entity becomes a wholly-owned subsidiary of the new parent (paragraph 37A of the proposed amendments to AASB 127/IAS 27). In our view, this requirement unnecessarily restricts the application of the 'exemption' and would call into question whether conceptually equivalent transactions should be accounted for at fair value, e.g.:

- where the existing entity has options, preference shares, or other forms of non-ordinary equity on issue that are not part of the transaction
- transactions in which a controlling individual shareholder holding a direct personal interest in an entity chooses to incorporate a new holding company to hold his or her interest in the controlled entity.

The above examples also illustrate the difficulties that implementing the proposed amendments might create.

However, in the event the IASB proceeds with the proposed amendment, we suggest that the reference to "wholly-owned subsidiary" be removed from paragraph 37A and instead the principles outlined in paragraphs BC21-BC22 of the Basis of Conclusions to ED 160 be used to develop criteria to determine the eligibility to applying the 'exemption'. These criteria,

which are based on the substance of the transaction, could focus on the lack of a transfer of resources outside the group and no change in the relative ownership interests of the owners of the existing entity.

Question 6 - Transition

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

We agree with the proposal that the new requirements should be applied prospectively. We see no advantage in requiring retrospective restatement which would create additional work for no clear benefit.

However, some entities that have already made the transition to IFRSs for their separate financial statements may feel disadvantaged by not having been able to apply the new requirements at that time. We therefore believe that retrospective application should be permitted but not required.

Other matters

Amendment to IAS 21

We disagree with the proposed amendment to paragraph 49 of IAS 21. The first sentence of that paragraph lists methods by which an entity may “dispose” of its interest in a foreign operation for the purposes of applying paragraph 48 of IAS 21. That list includes “repayment of share capital” but does not include receipt of dividends which is dealt with in the second sentence. Therefore, deletion of the second sentence as proposed may, in effect, prohibit the recognition in profit or loss of the exchange differences deferred in a separate component of equity. We therefore propose that the first part of the sentence (“The payment of a dividend is part of a disposal only when it constitutes a return of the investment”) is retained and only the second part (“for example when the dividend is paid out of pre-acquisition profits”) is deleted.

Dividends receivable

The first sentence of draft paragraph 37B of IAS 27 should refer to “dividends received and receivable” rather than just “dividends received”. This would be consistent with paragraph 30(c) of AASB 118/IAS 18 *Revenue* which provides that dividends are recognised when the shareholder’s right to receive payment is established.