Australian Government

Australian Accounting Standards Board

Level 7, 600 Bourke Street
MELBOURNE VIC 3000
Postal Address
PO Box 204
Collins Street West VIC 8007
Telephone: (03) 9617 7600
Facsimile: (03)9617 7608

27 February 2008

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

E-mail: commentletters@iasb.org

Exposure Draft of Proposed Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* and IAS 27 *Consolidated and Separate Financial Statements* – Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate

The Australian Accounting Standards Board (AASB) welcomes the opportunity to comment on the above IASB's Exposure Draft.

The AASB generally supports the basis for the proposals in the Exposure Draft, especially in respect of the accounting treatment for restructures that result in the creation of a new parent entity. The AASB acknowledges that there are a variety of views as to how IAS 27 applies to such reorganised structures and that clarification is welcome. The AASB appreciates the efforts of the IASB to address an issue specifically of concern to Australian entities, particularly financial institutions.

In the formation of new parent entities, where there is no change in the beneficial ownership or the relative ownership interests of an entity or group, the AASB believes that it would be appropriate to account for the investment in subsidiary in the new parent's books at the existing carrying value of the net assets of the old parent. While the transaction is external to the group (in that it is with the parent's shareholders), the formation of a new parent is effectively a restructuring of the existing shareholders' legal ownership of the group – without any change in the economic interests of any of the existing owners.

Accounting for the new parent's acquisition of its investment in the old parent at fair value can have adverse consequences for the shareholders. The fair value of the old parent is often significantly higher than the carrying value of its net assets. Measuring the investment at fair value might result in future impairment write-downs of the investment that would be reflected in the income statement, and this may affect the new parent's ability to pay dividends to the shareholders.

The possible adverse outcomes for shareholders, arising from an exchange of their existing shares for shares in a new parent formed specifically for the purpose of creating a non-operating holding company structure, would not reflect the substance of the new formation – that is, that there has been no change in the shareholders' interests in the group. The proposed amendments in this Exposure Draft will remove those adverse accounting consequences.

However, the AASB has identified a number of concerns with the current proposals, including those listed below:

- the definition of dividends, specifically in respect of its reference to profits in IAS 18;
- onerous impairment testing requirements that will result from the receipt of dividends from an investment in a subsidiary, jointly controlled entity or associate;
- implications of the phrase 'the date of formation' in proposed paragraph 37A;
- implications of the term 'wholly-owned subsidiary' in proposed paragraph 37A;
- the scope of proposed paragraph 37A to either the creation of a new parent as the ultimate parent or at lower levels within a group structure; and
- the amendments can only be applied prospectively

These points are discussed in further detail in the responses to the specific questions accompanying the Exposure Draft, in the attachment to this letter.

In formulating its views, the AASB sought and considered the views of Australian constituents.

If you have any queries regarding any matters in this submission, please contact Natalie Batsakis (nbatsakis@aasb.com.au) or myself.

Yours sincerely

David Boymal
Chairman

Exposure Draft of Proposed Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* and IAS 27 *Consolidated and Separate Financial Statements* – Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate

Specific comments

The AASB provides the following responses to the questions raised in the Exposure Draft.

Question 1—Deemed cost

The exposure draft proposes to allow an entity, at its date of transition to IFRSs in its separate financial statements, to use a deemed cost to account for an investment in a subsidiary, jointly controlled entity or associate. The exposure draft proposes that an entity may choose as the deemed cost of such investments either the fair value or the previous GAAP carrying amount of the investment at the entity's date of transition to IFRSs (see paragraphs 23A and 23B of the draft amendments to IFRS 1 and paragraphs BC8–BC13 of the Basis for Conclusions).

Question 1

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

Yes. The AASB supports the IASB's proposal because the relief will assist in the smoother adoption of IFRSs in jurisdictions that are yet to commence the transition from previous GAAP.

The AASB also notes that using a pre-transition date fair value, such as the exemption provided in IFRS 1 for property, plant and equipment would also be another acceptable measure of deemed cost.

Question 2—Change in scope

The exposure draft proposes that the deemed cost option should be available for the initial measurement of investments in jointly controlled entities and associates when an entity adopts IFRSs in its separate financial statements (see paragraph BC14 of the Basis for Conclusions).

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?

Yes. The AASB considers that the issues that arise on transition to IFRSs when determining the carrying amount of an investment in a subsidiary also arise when initially recognising investments in jointly controlled entities or associates. An entity may not have the accounting documentation necessary to identify the original cost of its investment, and determining fair value may be costly.

Questions 3 and 4—Cost method

The exposure draft proposes to delete the definition of the 'cost method' from IAS 27. Additionally, the exposure draft proposes to amend IAS 27 to require an investor to recognise as income dividends received from a subsidiary, jointly controlled entity or associate in its separate financial statements. The receipt of this dividend requires the investor to test its related investment for impairment in accordance with IAS 36 *Impairment of Assets* (see paragraphs 4 and 37B of the draft amendments to IAS 27 and paragraphs BC15–BC20 of the Basis for Conclusions).

Question 3

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

Yes. The AASB acknowledges that, on pragmatic grounds, it is suitable to remove the existing definition of the cost method from IAS 27. It can be argued that the identification of particular dividends as being sourced from either pre or post-acquisition retained earnings, which is required as a consequence of the definition of the cost method, is arbitrary in many circumstances. In addition, removing the definition of the cost method will avoid current interpretation issues surrounding the deduction of distributions in the nature of returns of capital from the cost of the investment.

The AASB considers that the removal of the definition of the cost method will appropriately remove an impediment to entities undertaking a group restructure that involves creating a new parent entity. In such restructures, the current requirements of IAS 27 can result in pre-acquisition retained earnings being unavailable for payment of dividends to the ultimate shareholders. Therefore, in the event that the proposal is not retained, the AASB suggests that the IASB consider retaining the proposal at least for restructures that create a new parent entity, because removing the pre and post-acquisition status of retained earnings and other distributable reserves avoids dividend traps that can arise in group restructures.

The AASB notes that a definition of cost is currently located in IASs 16, 38 and 40. The AASB considers that with the removal of the definition of the cost method, it is timely for the IASB to determine more broadly what the definition of cost should be across its entire suite of standards, so as to prevent its inappropriate application. For example, in the context of IAS 27, some may determine the cost of a subsidiary with reference to the fair value of the investment received rather than the consideration paid.

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?

Recognition of dividends as income

Although we agree with removing the definition of the cost method, the AASB considers that in finalising the amendments, the IASB should clarify the implications of the removal of the definition of the cost method. It is clear that it will result in the recognition of all dividends as income, but it is unclear whether it will be applicable to all types of distributions, or only to dividends paid from profits (per definition in paragraph 5(c) of IAS 18). The AASB believes that consideration should be given to whether the definition of dividend needs to be revised in relation to the reference to "profits" in IAS 18. For example, clarification could be provided as to whether profits are from current year profits only, from retained earnings, from reserves held

in equity that are recycled or from reserves held in equity that are not recycled, and how accounting adjustments made to prior years impact the notion of profits. These are many of the issues that countries required to have "dividends only paid out of profits" are currently facing, where profits are not defined in legislation/regulation. The AASB notes that even under a full fair value model, it is not clear how dividends should be treated, whether they are a reduction in the asset value, or whether they are separate components to be recognized directly in the income statement.

The AASB views the recognition of all dividends as income as a change in principle and considers that the IASB's rationale should be documented more clearly in the Basis for Conclusions.

Consequential impairment testing

Whilst accepting that there may be a need for impairment testing, the AASB is concerned that the consequential requirement to test an investment for impairment when a related dividend is paid is too onerous. The AASB does not believe that the IASB's proposal is sufficiently justified in the Exposure Draft. The AASB considers that the requirement would be unduly onerous, especially for larger groups with many investments that pay several dividends to the parent during each reporting period. The AASB considers that the costs of testing for impairment each time a dividend is paid would outweigh the benefits that would be achieved. Instead, the AASB recommends that the payment of a dividend from a subsidiary, jointly controlled entity or associate be included as an indicator of impairment in paragraph 12 of IAS 36.

If the current proposals are to be retained (i.e. an investment must be tested for impairment when it pays a dividend to its parent), the AASB notes that it could be interpreted in two ways:

(i) impairment testing of an investment is required whenever a dividend is paid from the entity's investment in a subsidiary, jointly controlled entity or associate; or

(ii) impairment testing of the investment is required at each reporting date if one or more dividends are received from the entity's investment in a subsidiary, jointly controlled entity or associate during the reporting period.

The AASB considers that the first interpretation would be an unnecessarily onerous requirement for entities that pay dividends regularly throughout a reporting period, whereas the second interpretation is consistent with the requirements in paragraphs 10(a) and 10(b) of IAS 36 (i.e. test for impairment on an annual basis). Accordingly, the AASB recommends that proposed paragraph 10(c) should be rewritten to more clearly articulate that the receipt of dividends from an investment would only result in a test of impairment at each reporting date.

In addition, the AASB also suggests that the kind of relief as provided in paragraphs 15 and 99 of IAS 36 should be available when testing the impairment of an investment, and that if the current proposals are retained, these paragraphs should not just apply to goodwill and other intangibles. This will provide users with some relief from having to re-estimate the investment's recoverable amount at each reporting date.

The AASB also suggests that the IASB express more clearly:

(i) the scope of proposed paragraph 10(c). The current proposed wording to be included in IAS 36 would be applicable to all investments. The AASB does not consider this to be appropriate. It should only be applicable to those investments that are carried at cost. Investments carried at fair value should be tested for impairment in accordance with IAS 39;

(ii) whether it is possible to reverse an investment's impairment write-down that arises as a result of the payment of a dividend from a subsidiary, jointly controlled entity or associate; and

(iii) the appropriate accounting treatment for an investment's impairment write-down arising as a result of the payment of a dividend.

Question 5—Formation of a new parent

The exposure draft proposes that in applying paragraph 37(a) of IAS 27 to the formation of a new parent, the new parent should measure cost using the carrying amounts in the separate financial statements of the existing entity at the date of the formation (see paragraph 37A of the draft amendments to IAS 27 and paragraphs BC21 and BC22 of the Basis for Conclusions).

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?

Yes. The AASB supports the overall direction and objective of proposed paragraph 37A that will require a new parent to record the cost of its investment in the existing parent using the carrying amount of the net assets of the existing parent in its separate financial statements. However, the AASB has a number of concerns with the current drafting of proposed paragraph 37A which are outlined below.

(i) The formation date

Some constituents have identified that there may be an issue with the wording in proposed paragraph 37A which states that "...the new parent shall measure...at the date of formation." The issue arises because, before the new entity becomes a parent, it may be created as a subsidiary of the existing parent, and this may be some time before the restructure to create a new parent. The time between its formation as a subsidiary and as the new parent may significantly alter the accounting outcome. The AASB therefore suggests that the wording "...at the date of formation" is replaced with wording that more accurately reflects the event taking place, for example, "at the date of the restructure creating a new ultimate parent". (Refer to point (iii) below for the need for the reference to 'ultimate parent entity'.)

(ii) Use of the term 'wholly-owned subsidiary' in proposed paragraph 37A

The AASB is concerned that the current proposed wording does not address a situation where the existing parent has classes of equity in addition to ordinary shares. For example, options or preference shares with a capped equity claim (as shown in Table 1). In restructures that create a new parent, whilst the ordinary shareholders will undertake a share exchange, swapping shares in the existing parent for those of the new parent, other equity holders that exist both before and after the restructure, may not be transferred to the new parent. However, whilst the other equity holders are not transferred, the respective claims of all classes of equity remains unchanged.

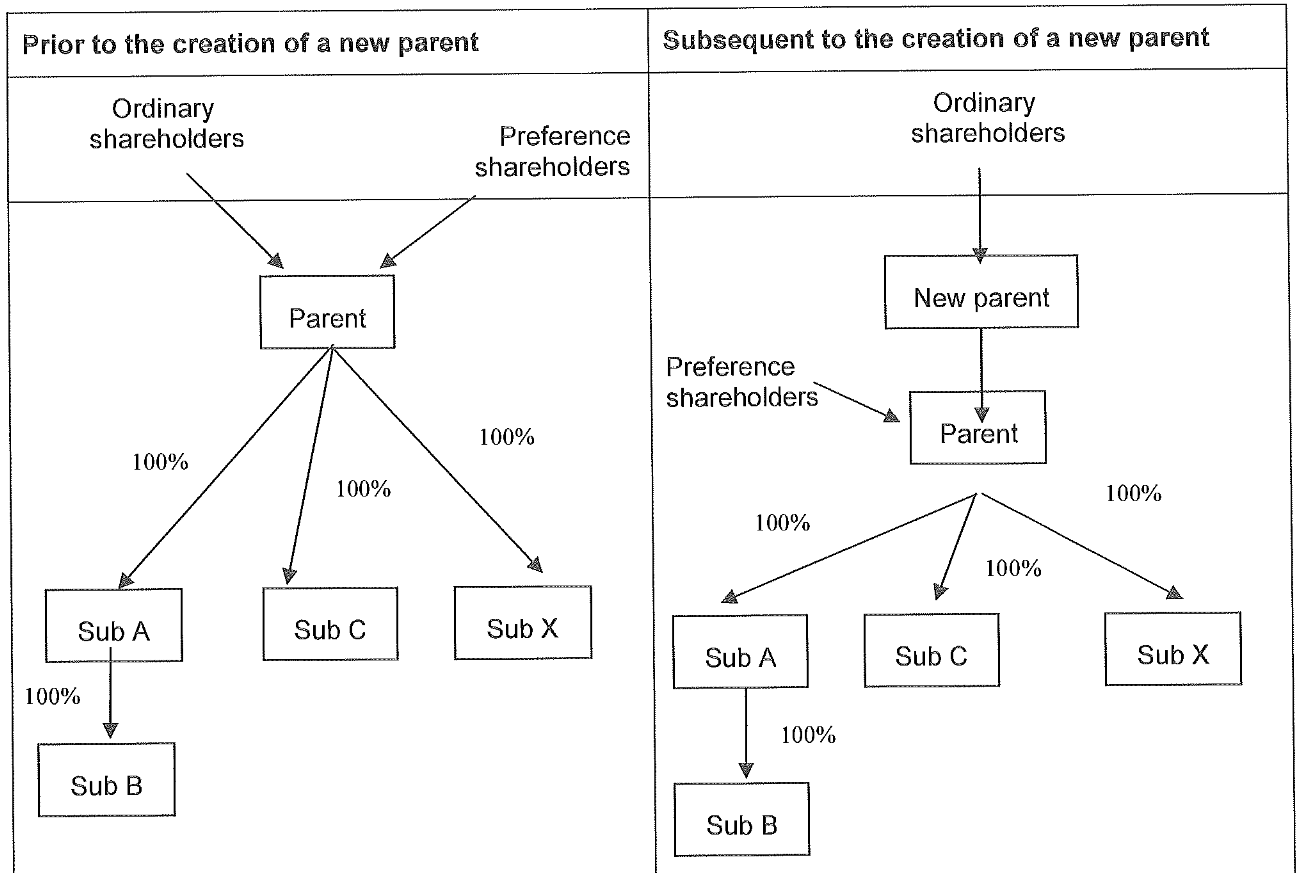

Table 1: Creation of a newly formed parent and the transfer of shares

The AASB understands that the reference to 'wholly-owned subsidiary' was added to the proposed wording with the purpose of preventing misuse of the amendments. However, as mentioned above, the AASB is concerned that the reference will inadvertently prevent some entities from applying the proposed amendments. The AASB notes that the IASB has not used such a preventative measure in respect of other exemptions or rules. For example, the common control exemption is not limited to 'wholly-owned subsidiaries'.

Therefore, the AASB recommends that the reference to 'wholly-owned subsidiary' be removed from proposed paragraph 37A (and proposed paragraph BC21 of the Basis for Conclusions), and also suggests that the second sentence of proposed paragraph BC21 be removed. In its place, the IASB should consider developing principle-based criteria based on those outlined in the second sentence of proposed paragraphs BC21 to be located in the body of the Standard, amended to clarify that the amendments can only be applied where there is no change in:

(a) the relative ownership interests of the owners of the existing entity pre-restructure and the relative ownership interests of the owners in the new combined group of the new parent and the remaining existing entity; and

(b) the equity, assets or liabilities of the group.

Furthermore, the IASB could limit any unintended misuse of the amendments by ensuring that the scope of the amendments clearly only apply to restructures where a new entity is created as the ultimate parent entity (see point (iii) below).

(iii) Scope of proposed paragraph 37A: any new parent or only a new ultimate parent?

The AASB understands, and agrees, that it is not the IASB's intention to address common control issues as part of this Exposure Draft and that the common control exemption is to be retained unamended until the completion of the project on common control.

The AASB notes that there is mixed interpretation regarding the words "...(either a parent or a single entity)..." in proposed paragraph 37A. Some are of the view that the amendments are only applicable to the creation of a new ultimate parent, whilst others view the amendments as being available when accounting for the creation of new intermediate parent entities at lower levels of a group.

The AASB anticipates that the accounting treatment for the creation of new entities at lower levels within a group will be addressed as part of the common control project. Therefore, the AASB recommends that the IASB clarifies that the proposed amendments only relate to the creation of a new entity when it is the ultimate parent entity and not an intermediate parent entity.

(iv) Clarification of the amount of the investment to be recorded in the new parent

In determining the amount that the new parent will record in its separate financial statements as the investment in the existing parent, proposed paragraph 37A and paragraph BC22 of the Basis for Conclusions make reference to the "equity, assets and liabilities in the separate financial statements of the existing entity".

The AASB recommends that the IASB specify either "equity in the separate financial statements of the existing entity" or "net assets/assets and liabilities in the separate financial statements of the existing entity" to remove any confusion as to its measurement base.

(v) Proposed Paragraph 37A could be optional

The AASB suggests that consideration be given to making the proposed requirements in paragraph 37A optional. This would address issues in jurisdictions where fair value measurement is required.

Question 6—Transition

The exposure draft proposes that the amendments to IFRS 1 and IAS 27 shall be applied prospectively.

Question 6

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

No. The AASB believes that entities should be able to apply the amendments in this Exposure Draft retrospectively from the first day of the comparative period. The AASB regards the focus of these amendments as being similar in nature to the introduction of IFRS 3 *Business Combinations* for business combinations and notes that some Australian entities have already undertaken transactions to create a new parent entity.

IFRS 1, Appendix B, Business Combinations, paragraph B1, permits an entity to elect whether or not to apply IFRS 3 requirements retrospectively, and if it decides to do so, to apply them to all transactions from the date of application.