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Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
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30 April 2007

Dear Sir David

Proposed amendment to IFRS 1 First-time Adoption of International Financial Reporting Standards: Cost of an Investment in a Subsidiary

Deloitte Touche Tohmatsu is pleased 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*. This letter sets out our main comments to the Exposure Draft. Our responses to the specific questions raised in the Exposure Draft are set out in the Appendix.

Use of deemed cost

We welcome the fact that the Board has taken this issue on to its agenda. The proposals in the Exposure Draft address a real concern that it may be impracticable to apply IAS 27 with full retrospective effect on transition. This is creating a significant barrier, in some jurisdictions, to the adoption of IFRSs for the separate financial statements of parent companies. Addressing the issue should therefore lead to wider use of IFRSs and reduced costs for companies because they will no longer have to prepare financial statements under local GAAP.

The Board rejected the use of a deemed cost based on previous GAAP carrying amount on the grounds that it might bear little resemblance to cost in accordance with IAS 27. We agree that this may be true in some cases but question whether it is should lead to requirements that are more onerous than those of IFRS 1 for business combinations. For example, assets (including goodwill) may be stated at significantly different amounts than would be required by IFRSs if a business combination before the date of transition was accounted for using the pooling of interests method. It does not appear to us to be appropriate to take a stricter line for the separate financial statements of a parent company.

We would therefore urge the Board to reconsider whether a simple exemption based on previous GAAP carrying amount (subject to an impairment test) could be justified on cost / benefit grounds. This would be consistent with the existing exemptions in IFRS 1 for business combination as noted above and in other respects.

The Board’s conclusions may have been based on the concern expressed in BC1 that the previous GAAP carrying amount might be a very low amount based on the nominal value of the shares issued. This is true in some cases but it is likely that, in many more instances, the carrying amount will be broadly comparable to fair value at the date of acquisition but will not have been adjusted for dividends received out of pre-acquisition profits as required by IAS 27. Another common practice, in some jurisdictions, is for the investment in subsidiaries to be carried at an amount based on the underling local GAAP net asset value of the subsidiaries (i.e. application of the equity method). This may often be similar to the IFRS net asset value but considerable work might be required to confirm this. It is questionable whether requiring a restatement in these circumstances is justified on cost benefit grounds.

However, if the Board reaffirms its decision that it cannot support an exemption based on a previous GAAP carrying amount, we agree that the proposals in the Exposure Draft will provide a practicable solution in most cases. We particularly welcome the choice of two methods to arrive at deemed cost. The approach based on IFRS net asset value will virtually always be possible from the available records although it will require some work. This approach will, nevertheless, usually lead to a significant reduction in the carrying amount of the investment and an equivalent debit within equity. This is because the IFRS net asset value will not include any goodwill arising on the acquisition which will, however, be included in the previous GAAP carrying amount. The resulting reduction in net assets may be unattractive to many companies for commercial, legal or regulatory reasons.

Companies in this position could potentially use the alternative approach of fair value at the date of transition. This will often involve considerably greater cost and effort and may be regarded as impracticable in some cases. One or other approach should address the needs of most companies (except where it is regarded as impracticable to determine fair value) although at a greater cost than one based on previous GAAP carrying amount.

As noted above, the IFRS net asset value approach may be unattractive to some companies where it leads to a reduction in the carrying amount. A potential modification to the proposals is that when using the net asset value basis leads to a reduction in the net assets of the parent, deemed cost may instead be determined by reference to previous GAAP (subject to impairment testing). The effect of this would be that deemed cost is the higher of the previous GAAP carrying amount and the IFRS net asset basis. This approach would address the Board’s concerns about artificially low values based on the nominal value of shares issued.

The Exposure Draft does not include any guidance on how IFRS net asset value should be determined. We are aware that some commentators have queried the need for more guidance on this and we acknowledge that there are some issues. For example, a subsidiary might have a different date of transition to IFRSs than its parent or prepare IFRS financial statements only for the purposes of consolidation which might include fair value adjustments arising on its acquisition. In this case, it is unclear whether it is the Board's intention that the figures used for consolidation should be used for the purposes of the exemption, or whether it is necessary to determine what figures would appear in individual financial statements of the subsidiary, had they been prepared. Another issue is that, in the case of a vertical group, it is not clear from the ED whether the IFRS net asset value should be determined on the basis of a simple aggregation or whether a sub-consolidation is necessary (we assume that the former was intended but would welcome clarity on this). Also, the subsidiary might also make different accounting policy choices even if reporting under IFRSs.

It will be common in some jurisdictions (e.g. some countries within the EU) for the subsidiaries to adopt IFRSs at a later date than the parent in relation to its consolidated financial statements. Similarly, it may be common for the parent, in its separate financial statements, to transition to IFRSs at a later date than the consolidated financial statements.

We believe that the Board should carefully consider the need for implementation guidance on these issues although we acknowledge that there is a balance to be struck as to the level of detailed rules that are appropriate. Alternatively, the Board should make it clear in the Basis for Conclusions to the amendment why it did not consider further guidance to be necessary.

The treatment of dividends

We have a significant concern about the proposals in the Exposure Draft on the treatment of dividends received after the date of transition when the deemed cost exemption has been used. The proposals require that, in this case, all of the subsidiary's accumulated profits under IFRSs at the date of transition are treated as pre-acquisition accumulated profits. We understand the rationale given in BC8 and the Board's wish to avoid a 'double credit'. However, this does not take account of the fact that the adoption of the IFRS net asset value approach will very often result in a reduction in the carrying amount of the investment (unless our recommendation in the previous paragraph is adopted). Companies in this situation may in fact suffer a 'double debit' rather than a 'double credit'.

For example, a subsidiary may have substantial accumulated profits at the date of transition which are known to have been earned post-acquisition. However, its parent may have to use the deemed cost exemption because it is unable to determine whether any dividends were received out of pre-acquisition profits many years ago and credited to income. The parent's cost of investment is based on fair value at the date of acquisition. If the parent elects to use IFRS net asset value as deemed cost, it will first suffer a debit to equity on transition. It will also be unable to record as income the receipt of dividends out of the post-acquisition profits of its subsidiary resulting in a further reduction in equity compared with what it would have been if the exemption had not been used.

A solution to this problem could be to amend B6(a) to state that when the deemed cost exemption is used, all dividends subsequently received are deemed to be out of post-acquisition profits, subject to a requirement to test the investment for impairment. However, if the Board is unable to accept this proposal, an alternative solution is to say that profits should be regarded as pre-acquisition only to the extent that the deemed cost is higher than the previous GAAP carrying amount. This approach avoids the ‘double credit’ problem identified in BC8 without creating a ‘double debit’ issue for other companies.

Other matters

The accounting treatment for investments in associates and jointly controlled entities in the separate financial statements of the investor is the same as that for subsidiaries. The same issues can arise about the cost of investment in an associate or jointly controlled entity as those addressed in the Exposure Draft. The amendment to IFRS 1 should therefore be framed more generally as applicable to investments accounted for in accordance with IAS 27(37).

The Exposure Draft places the new exemptions within Appendix B to IFRS 1 which deals with business combinations. The issues addressed in the Exposure Draft are not about accounting for business combinations. They concern the separate financial statements. Many investments to which the proposals will apply will have been accounted for as business combinations in the consolidated financial statements of the parent but this will not always be the case. Therefore it would be appropriate to relocate the proposed new exemptions within the body of the standard (e.g. somewhere near the current paragraphs 24 and 25). We are aware that there is a current project to restructure IFRS 1 and it may be appropriate to address this issue as part of that project.

We also urge the Board to review, as part of the project to revise IAS 27, the treatment of dividends received out of pre-acquisition profits. 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 subsidiary. There are complexities when applying the requirements of IAS 27 in practice which would be reduced by a less rule based approach. In some jurisdictions a simpler approach is used under their local GAAP that presumes that any distributions received are a return *on* capital rather than a return *of* capital unless the effect is to result in an impairment of the investment. We would welcome a broader debate on these issues without necessarily implying that we would support such a simplified approach.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907.

Sincerely

Ken Wild
Global IFRS Leader

Appendix

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 its fair value, at that date. Is this appropriate? If not, why?

As more fully explained in our covering letter, we favour an exemption which permits the use of previous GAAP carrying amount (subject to an impairment test) as deemed cost which is meaningful.

However, we agree that the proposals in the Exposure Draft provide a practical solution to the issues addressed in most cases even though at a greater cost than an exemption based on previous GAAP carrying amount.

We also explain in our covering letter that the use of the IFRS net asset value approach will often lead to a reduction in the carrying amount of the investment compared with previous GAAP because of the existence of goodwill in the consolidated financial statements that is not taken into account when calculating the net asset value of the subsidiary under the currently proposed exemption. This may discourage preparers from adopting this approach. We put forward a proposal to deal with this.

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 determine the pre-acquisition accumulated profits of a subsidiary for the purpose of the cost method in IAS 27. Is this appropriate? If not, why?

We agree that a simplified approach is required to deal with this issue.

As explained in our covering letter, the proposals in the Exposure Draft may in many lead to a 'double debit' to equity in many cases. We put forward proposals to deal with this.