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FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE

Accounting

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Endorsement of the 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"

Introduction, background and conclusions

Attachment 1: Effect study prepared by the European Financial Reporting Advisory Group (EFRAG)

Attachment 2: Endorsement advice prepared by EFRAG

1. EFFECT STUDY

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union (EU). The Commission Services together with the European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU.

EFRAG has prepared an Effect Study for the 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" (attached). As the EFRAG Effect Study refers to the Endorsement Advice, we also included it in attachments.

This cover note contains background information, comments and a conclusion by the Commission Services.

2. BACKGROUND ON THE AMENDMENTS TO IFRS 1 AND IAS 27

Explanation of the issue

The IASB added this project to its agenda in March 2006 to address issues that have arisen in practice related to the determination of the cost of an investment in a subsidiary, jointly controlled entity or associate in the separate financial statements.

The IASB published a first Exposure Draft in January 2007 and as the concerns were not mitigated, decided to publish a second Exposure Draft in December 2007. The final document was published in May 2008.

In some countries listed companies have a choice of preparing the separate financial statements in accordance with local GAAP or IFRS. Many companies have continued to use local GAAP and one of the stated reasons for this is the current requirements for first application of IFRS. If a company decides to move to IFRS and account for its investments at cost in its separate financial statements, there is a need under current IFRS 1 to retrospectively determine the cost of the investments. In order to do this a company will need:

- to measure the fair value of the consideration given at the date of acquisition; and

- to assess whether any dividends received after the acquisition date were paid out of pre-acquisition accumulated profits. Under current standards dividends that correspond to pre-acquisition accumulated profits are regarded as a recovery of the investment and are recognised as a reduction of the cost of the investment.

These requirements involve in some circumstances undue cost and effort and will lead to additional accounting cost for first time adopters.

There were also some problems with the current definition of the "cost method" and some enquiries to apply the same treatment to all dividends, eliminating the distinction between pre- and post-acquisition accumulated profits.

Additionally some clarification was needed for the accounting in the separate financial statements of some specific types of reorganizations when a new parent is created.

How is the issue dealt with currently?

Currently, paragraph 38 of IAS 27 allows to account for investments in subsidiaries, jointly controlled entities or associates in the separate financial statements at either cost in accordance with IAS 27 or fair value in accordance with IAS 39.

Under current IFRS 1 there is no exemption from this requirement. First time adopters choosing to account for their investments at cost are required calculate the cost in the date of acquisition (retrospective application). This has raised concerns, and as result some entities have been discouraged from the application of IFRS.

IAS 27 currently requires the application of the "cost method" in accounting for dividends received from investments in subsidiaries, jointly controlled entities or associates. This means that dividends paid out of pre-acquisition accumulated profits of such investments are to be treated as a reduction in the cost of the investment, and dividends paid out of post-acquisition profits are to be treated as income.

How do the amended IFRS 1 and IAS 27 suggest dealing with the issue?

The document proposes the following amendments:

- In addition to the current alternative for an entity that applies IFRS for the first time to measure the cost in accordance with IAS 27, the amendment allow to account for its investments in a subsidiary, jointly controlled entity or associate in its separate financial statements at its "deemed cost". This cost shall be either its fair value (determined in accordance with IAS 39) at the entity's date of transition to IFRS, or its previous GAAP carrying amount at that date.

- Delete from IAS 27 the definition of the "cost method" and as a consequence all dividends received from investments in subsidiaries, jointly controlled entities or associates will be treated as income. There will be no difference in treatment depending on whether the dividends correspond to pre- or post-acquisition accumulated profits as this notion will be eliminated. Additional guidance of indicators of possible impairment is included in IAS 36 *Impairment of Assets*. The amendment focuses on whether the payment of the dividend might have resulted in the investment becoming impaired.

- Clarify how to determine the costs of an investment in accordance with IAS 27 when an entity reorganises the structure of its group by establishing a new entity as its parent and the new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent. The amendments require the new parent to measure cost as the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

The proposed amendments will become effective for annual periods beginning on or after 1 January 2009, with earlier application permitted.

IASB and EFRAG consultations

The IASB carried out a consultation according to its due process. The IASB published a first Exposure Draft on January 2007 and received 47 comment letters. In the light of the comments, the IASB decided to publish a second Exposure Draft on December 2007; in this case the IASB received 64 comment letters. The results of the second consultation showed that respondents generally supported the proposed amendments to IFRS 1 and IAS 27 as the IASB had revised some of the proposals. The final document with the amendments was published in May 2008.

Commentators to the EFRAG consultation unanimously shared EFRAG´s assessment of the costs and benefits associated with the implementation of these amendments. EFRAG also discussed the potential cost and benefits with its User Panel.

3. EFFECT ANALYSIS

Main points identified in the EFRAG Effect Analysis

Usefulness of accounting information provided in the financial statements

EFRAG's analysis concluded that the amendments to IFRS 1 and IAS 27 will improve the quality of the financial information provided in separate financial statements concerning investments in subsidiaries, jointly controlled entities and associates.

EFRAG noted that the amendments will result in a general improvement in the quality of the financial reporting as it will make it easier for investors to adopt IFRS in their separate financial statements. Therefore the proposals are likely to result in more entities adopting IFRS. EFRAG raised some concerns as accounting options are widened by the amendments, but concluded that a more spread IFRS use is likely to overall increase comparability of accounts of first-time adopters.

The Commission Services agree with the EFRAG analysis and conclude that the amendments to IFRS 1 and IAS 27 will overall improve the quality of the financial information and therefore will benefit users.

Costs for preparers and users

EFRAG's analysis gives an overview of the expected incremental costs for preparers and users. With regard to preparers, EFRAG considered that the amendments proposed to IFRS 1 and IAS 27 is likely to result in a reduction of the accounting costs for the vast majority of preparers.

Users will incur in some incremental year one cost to understand the amendments and they can also be faced with some comparability issues. EFRAG concluded that users may incur some incremental costs, but these are likely to be insignificant.

EFRAG notes that the amendments will in most cases result in a reduction of the costs for preparers. In some additional costs may occur for users, but these are likely to be insignificant. The Commission Services share this analysis.

4. OVERALL COST-BENEFIT CONSIDERATIONS AND COMMISSION SERVICES CONCLUSIONS

On the basis of EFRAG's Effect Study, the Commission Services have considered the main costs and benefits of endorsing the amendments to IFRS 1 and IAS 27 and concluded that the benefits of adopting the amendments outweigh the costs incurred.

The Commission Services believe that the amendments to IFRS 1 and IAS 27 will have positive cost-benefits effects and that it should therefore be endorsed in the EU without delay.

Attachment 1

EFRAG
European Financial Reporting Advisory Group

The costs and benefits of implementing of the amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (the Amendments).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this). Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the amendment in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A summary of the amendments to IFRS 1 and IAS 27

Deemed cost

4 When an entity prepares its first IFRS financial statements, unless IFRS 1 contains an exemption from applying a requirement in an other IFRS, the entity shall, in its opening

IFRS balance sheet, apply those other IFRSs in full when recognising and measuring assets and liabilities.

5 IAS 27 requires that an entity with an investment in a subsidiary shall measure that investment in its separate financial statements at either cost or fair value. Similar requirements apply in the case of investments in jointly controlled entities and investments in associates. Under existing IFRS 1 there is no exemption from this requirement.

6 Measuring such investments at cost on transitioning to IFRS is difficult for those entities that have been required or permitted by local GAAP to account for such investments at an amount other than cost.

7 The Amendments change IFRS 1 so that a first-time adopter is permitted, in its separate financial statements, to use as the deemed cost of an investment in a subsidiary, jointly controlled entity or associate either fair value (determined in accordance with IAS 39) at the entity's date of transition to IFRSs or the previous GAAP carrying amount at that date. Thus, an entity can either choose to apply IAS 27—and as a result measure such investments at cost or fair value—or choose to apply the new exemption at its date for transition to IFRSs—and therefore measure such investments at either the transition date fair value or the transition date local GAAP carrying amount.

Deletion of the cost method in IAS 27

8 Currently, IAS 27 requires application of the so-called cost method in accounting for dividends received from investments in subsidiaries, jointly controlled entities and associates. This means that, when the investor receives a dividend from such an investment, it needs to determine whether the dividend is paid out of the accumulated profits of the investee that have arisen since the date of acquisition (ie 'post-acquisition profits') or pre-acquisition profits. Dividends paid out of post-acquisition profits are accounted for as income, and dividends paid out of pre-acquisition profits are treated as a reduction in the cost of the investment.

9 Accounting for such dividends in this way is difficult for those entities that have been required or permitted by local GAAP to account for such dividends differently.

10 The Amendments delete the cost method from IAS 27. This means that the investor is no longer required, when preparing its separate financial statements, to determine whether a dividend received from an investment in a subsidiary, jointly controlled entity or associate is paid out of post- or pre-acquisition profits. Instead, the investor is required to recognise such a dividend as income in profit and loss.

11 In accordance with existing IAS 36 *Impairment of Assets*, the investor is required to assess at each reporting date whether there is any indication that the investments may be impaired. If such an indication exists, the entity is required to carry out an IAS 36 impairment test. The Amendments amend IAS 36 to highlight some circumstances in which the receipt of a dividend from an investment in a subsidiary, jointly controlled entity or associate might indicate that the investment is impaired.

Measurement of cost in the separate financial statements of a new parent

12 The Amendments also clarify how to determine the cost of an investment in accordance with IAS 27 when a parent reorganises the operating structure of its group by establishing a new entity as its parent and this new parent obtains control of the

original parent by issuing equity instruments in exchange for existing equity instruments of the original parent. The result is that the assets and liabilities of the new group and the existing group are the same immediately before and after the reorganisation, as are the absolute and relative interests of the owners of the original parent in the net assets of those groups. In such circumstances the Amendments clarify that the cost of the investment in the original parent shall be measured at the carrying amount of the new parent's share of the equity items shown in the original parent's separate financial statements at the date of reorganisation.

Transitional arrangements

13 The Amendments state that:

(a) the changes described in paragraphs 4 – 7 apply to accounting periods beginning on or after 1 January 2009;

(b) the changes described in paragraphs 8 – 11 apply prospectively for annual periods beginning on or after 1 January 2009; and

(c) the changes described in paragraph 12 shall apply prospectively to reorganisations occurring in annual periods beginning on or after 1 January 2009.

In each case, earlier application is permitted. Entities are also permitted to apply the changes described in paragraph 12 retrospectively to past reorganisations, however if an entity applies it to past reorganisations, it shall restate all later reorganisations within the scope of the amendment.

EFRAG's initial analysis of the costs and benefits of the amendments to IFRS 1 and IAS 27 and Stakeholders' views on it

14 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the Amendments, both in year one and in subsequent years.

15 On the basis of that initial assessment, EFRAG tentatively concluded that the Amendments will improve the quality of the financial information provided and, as such, that its implementation will benefit users.

16 EFRAG further tentatively concluded that the amendments to IFRS 1 and IAS 27 will involve only insignificant incremental costs for preparers and users, and in some cases they could even result in cost savings.

17 Finally, EFRAG tentatively concluded that the benefits expected to arise from applying the Amendments were likely to exceed the costs involved in its implementation.

18 EFRAG published its initial assessment and supporting analysis on 30 May 2008. It invited comments on the material by 1 July 2008. The results of this consultation can be summarised as follows. Where specific responses to the questions posed were provided by respondents:

(a) All respondents agreed with EFRAG's assessment of the costs involved for users and preparers.

(b) All respondents agreed with EFRAG's assessment of the benefits associated with implementing the Amendments and with EFRAG's conclusion that the

benefits to be derived from application of the Amendments will exceed the costs involved.

19 In addition, EFRAG consulted its User Panel in June 2008 on the impact that the Amendments would have on users.

EFRAG's final analysis of the costs and benefits of the amendments to IFRS 1 and IAS 27

20 Based on its initial analysis and stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of the Amendments is presented in the paragraphs below.

Costs for preparers

21 EFRAG has considered whether applying the accounting treatment required by the Amendments would involve significant implementation (ie year one) or incremental recurring (ie ongoing) costs for preparers.

22 The amendment to allow an entity to use either fair value or the previous GAAP carrying amount as deemed cost when measuring, in its separate financial statements, investments in subsidiaries, jointly controlled entities and associates at its date of transition to IFRSs is intended to reduce the work involved—and therefore the cost—of transitioning to IFRS for those entities that choose to take advantage of the amendment. EFRAG believes that it will do that. Allowing previous GAAP carrying amount as deemed cost in particular will mean that no additional work will have to be done in relation to measurement of such investments at the date of transition to IFRSs.

23 The amendment to delete the "cost method" currently in IAS 27 means that henceforth preparers will not be required, when accounting for dividends received from investments in subsidiaries, jointly controlled entities and associates, to distinguish between pre- and post acquisition accumulated profit to determine whether the dividend is a return of the investment or not. This will mean less work—and therefore lower costs—for preparers. On the other hand, another amendment extends the list of indicators that an investment in a subsidiary, jointly controlled entity or associate might be impaired. These amendments will apply to all investors, not just to those transitioning to IFRS. This could mean that more IAS 36 impairment tests than hitherto will need to be carried out. EFRAG believes that, when this is the case, the amendment will result in incremental costs for preparers; however, it also believes that, for the majority of entities affected, the overall effect of this amendment will be a cost saving.

24 The Amendments require, when there has been a group reorganisation of the type described in new paragraphs 38B and 38C of IAS 27, the carrying amount of the equity interest in the original parent that has been exchanged for equity interests in the new parent shall be used as the cost of the new parent. This is intended to be a clarification of the existing requirement. Therefore, in assessing the costs for preparers that arise from this amendment, EFRAG has considered whether the accounting required by this amendment would involve more costs for preparers than any of the other approaches that might have been possible prior to the clarification. EFRAG is not aware of any approach that would have involved a lower cost. Therefore, EFRAG's assessment is that this amendment will involve a cost saving for some preparers and no change in cost for other preparers.

25 EFRAG believes that the transitional arrangements set out in the Amendments have no cost implications for preparers.

26 For the above reasons, EFRAG's assessment is that overall the implementation of the Amendments will involve additional costs only for a small number of companies that will need to carry out more IAS 36 impairment tests because they will no longer treat any part of a dividend received from an investment in a subsidiary, jointly controlled entity or associate as a reduction in the cost; the vast majority of preparers affected by these Amendments are likely to see a reduction in their costs.

Costs to users

27 Users will incur some incremental year one costs in understanding the effects of the Amendments on the comparability of the information provided by entities transitioning to IFRS from the implementation of the new requirements, if an entity applies a deemed cost as allowed by the amendment to IFRS 1. On the other hand, the Amendments are likely to result in increase in the number of entities applying IFRS in the parent financial statements, which will make it easier for users to analyse the information provided.

28 Similarly, the amendment to recognise all dividends from investments in subsidiaries, jointly controlled entities and associates as income in the investor's separate financial statements will involve some year one costs for users in understanding the amendment. However, EFRAG believes that the amendment ought to make the information more understandable, which is likely to result in a decrease in ongoing costs for users.

29 The amendment to clarify how certain types of group reorganisation should be accounted for ought not to involve users in any additional costs because it just clarifies the accounting that should have been adopted prior to the amendment.

30 The changes being proposed in respect of the cost of an investment will in effect apply to all future transitions to IFRS, but not to past transitions. Thus, there will be some comparability issues for users in comparing entities that have transitioned to IFRS at different times. The other changes are to be applied prospectively, which will also raise some comparability issues.

31 Therefore, users may incur some incremental costs. However, EFRAG's view is that these costs are likely to be insignificant.

Benefits for preparers and users

32 As the Amendments will make it easier for entities to transition to IFRS than hitherto, they are likely to result in more entities adopting IFRS. EFRAG believes that this will result in benefits.

33 EFRAG has also concluded, for the reasons explained in our Endorsement Advice, that the Amendments themselves will improve the information provided in separate financial statements about investments in subsidiaries, jointly controlled entities and associates.

Conclusion

34 EFRAG's overall assessment is that:

(a) implementing the Amendments will result in only insignificant incremental costs for both preparers and users. In some cases the Amendments may even result in cost savings for preparers;

(b) the Amendments will improve the quality of the financial information provided; and

(c) the benefits that will result from applying the Amendments to IFRS 1 and IAS 27 are likely to exceed the costs of doing so.

35 During its consultation process, EFRAG did not become aware of any factors other than those mentioned in this report that should be taken into account in assessing the costs and benefits of implementing the amendment in the EU.

EFRAG
21 July 2008

Attachment 2

EFRAG
European Financial Reporting Advisory Group

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

21 July 2008

Dear Mr Holmquist

The Amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the Amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (henceforth 'the Amendments'). The Amendments were preceded by two exposure drafts, both of which EFRAG commented on.

The Amendments:

- allow a first-time adopter in its separate financial statements to use as the deemed cost of an investment in a subsidiary, jointly controlled entity or associate either the fair value at the entity's date of transition to IFRSs or the previous GAAP carrying amount of the investment at that date;

- delete from IAS 27 the definition of the 'cost method', with the result that an investor is required to recognise as income in its separate financial statements all dividends received from a subsidiary, jointly controlled entity or associate, even if the dividend is paid out of pre-acquisition reserves.

- clarify how to determine the cost of an investment under IAS 27 when a parent reorganises the operating structure of its group by establishing a new entity as its parent and this new parent obtains control of the original parent by issuing equity instruments in exchange for existing equity instruments of the original parent.

The Amendments become effective for annual periods beginning on or after 1 January 2009, with earlier application permitted.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- they are not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- they meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the Amendments and, accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix
Basis for Conclusions

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the 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*.*

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as adviser to the European Commission on endorsement of the final IFRS or Interpretation on the issue.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the European endorsement criteria, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretation. Another reason for a difference is that EFRAG's thinking may evolve.

1 When evaluating the merits of the Amendments to IFRS 1 and IAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (the Amendments), EFRAG considered the following questions:

(a) Are the Amendments consistent with the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the Framework)?

(b) Would the Amendments' implementation result in an improvement in accounting?

(c) Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?

2 Having formed tentative views on the issues and prepared a draft assessment, EFRAG issued that draft assessment on 30 May 2008 and asked for comments on it by 1 July 2008. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.

3 In addition to amending IFRS 1 and IAS 27, the Amendments make consequential amendments to IAS 18 *Revenue*, IAS 21 *The Effects of Changes in Foreign Exchange Rates* and IAS 36 *Impairment of Assets*.

(a) EFRAG considers the amendments made to IAS 18 and IAS 21 to be a consequence of the amendments to IAS 27 and, as a result, not in need of separate evaluation.

(b) The amendment to IAS 36 does not change the requirements of the standard; it merely provides additional guidance as to the indicators of possible impairment. This means in EFRAG's view that the amendments to IAS 36 do not require a separate evaluation as the present requirements are already endorsed for use in the EU.

Are the Amendments consistent with the Framework?

4 EFRAG started its assessment by asking whether the Amendments are consistent with the Framework. In EFRAG's view, the aspects of the Framework that are most relevant for this purpose are the qualitative characteristics of relevance, reliability, comparability and understandability and the material dealing with the recognition of income and the measurement of the elements of financial statements.

(a) The Amendments will be judged against the qualitative characteristics later in this appendix, so this section does not focus on that aspect of the Framework.

(b) Paragraph 100 of the Framework describes a number of different measurement bases that are "employed to different degrees and in varying combinations in financial statements". It also defines what the Framework means by historical cost ("the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire [the asset] at the time of [its] acquisition"). The material in the Framework on measurement is nevertheless different from the material in other parts of the Framework in that it is not as definitive; it describes in fairly general terms the sort of measurement bases that entities are currently using but does not describe how assets and liabilities should be measured. As such, EFRAG believes that the question of whether a measurement basis required by the Amendments is consistent with the Framework does not arise.

Therefore, in this section EFRAG has focused on what the Framework says about income.

5 According to paragraph 92 of the Framework, income is recognised in the income statement when an increase in the future economic benefit related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably.

6 Under the Amendments, when the investor's right to receive a dividend from its investment in a subsidiary, jointly controlled entity or associate is established, income has arisen and should be recognised. EFRAG agrees that the right to receive the dividend will result in an increase in the entity's receivables and can be measured reliably and that, because there is not a directly-related decrease in another assets or increase in a liability, the right to receive a dividend represents income as defined in paragraph 92 of the Framework. Therefore, in EFRAG's view this accounting is consistent with the definition of and recognition criteria for income set out in the Framework.

Would the Amendments' implementation result in an improvement in accounting?

7 It is clear from the discussions that EFRAG has had during its meetings and from the comment letters it has received that it can be difficult for an entity applying IFRS for the first time in its separate financial statements to comply with the present requirements of IAS 27 relating to:

- the cost of an investment in a subsidiary, jointly controlled entity or associate; and
- the treatment of dividends received from such investments,

particularly if, under previous GAAP, the carrying amount of the investments has been measured in a manner that is not in accordance with the present IAS 27. EFRAG understands that these difficulties above are preventing some investors adopting IFRSs in their separate financial statements.

8 In EFRAG's view, the Amendments provide significant relief from those difficulties and, as a result, will make it easier for investors to adopt IFRSs in their separate financial statements. That is likely to mean that more entities with investments in subsidiaries, jointly controlled entities and associates will adopt IFRS in their separate financial statements. EFRAG believes that this will result in a general improvement in the quality of financial reporting.

9 EFRAG has also evaluated the impact of the Amendments on the specific information provided about investments in subsidiaries, jointly controlled entities and associates.

Comparability

<u>Deemed cost</u>

10 By allowing entities transitioning to IFRS to use in their separate financial statements transition date fair value or transition date previous GAAP carrying amounts as the deemed cost of their investments in subsidiaries, jointly controlled entities and associates, the Amendments have the effect of allowing such investments to be measured in one of four different ways: at cost or remeasured at fair value in accordance with IAS 27 as previously, or transition date fair value or transition date previous GAAP carrying amount. This will have an impact on comparability, both among first-time adopters applying this exemption and between future adopters of IFRS and entities already applying IFRSs.

11 On the other hand, this amendment (and the deletion of the cost method, which is discussed below) removes what for some entities is a significant barrier to the adoption of IFRS in the separate financial statement; in other words, it makes it possible for more entities to adopt IFRS. The more entities applying the same set of standards, the more comparable financial statements are in general.

12 Existing IFRS 1 contains a similar exception from IFRS 3 for the restatement of business combinations at the date of transition to IFRSs. The Amendments

extend that exception to the parent's separate financial statements and to investments in jointly controlled entities and associates, thereby achieving a degree of consistency.

Deletion of the cost method

13 Deletion of the cost method applies not only to first time adopters but also to all other entities applying IFRSs that have such investments. This means that future returns on such investments will be accounted for in the same way by all entities under the Amendments, regardless of the reserves the dividends are paid out of.

Measurement of cost in the separate financial statements of a new parent

14 Requiring, in the circumstances described in the Amendments, a new parent to measure the cost of its investment in the original parent in its separate financial statements at the carrying amount of its share of the equity items in the original parent should not reduce the comparability of the information provided because, in this particular type of reorganisation, the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation.

Understandability

Deemed cost and deletion of the cost method

15 Currently, IFRS requires first-time adopters to measure their investments in subsidiaries, jointly controlled entities and associates at the date of transition to IFRSs at either fair value or cost. Dividends received from pre-acquisition accumulated profits of such investments are to be treated as a reduction in the cost of the investment and dividends received from post-acquisition profits are to be treated as income. Henceforth, such investments could be measured by the investor in its separate financial statements on any one of four bases mentioned in paragraph 10 above. In addition, all dividends received from such entities are treated as income; the notion of paying dividends out of pre- or post-acquisition profits is eliminated and instead the focus is on whether the payment of the dividend might have resulted in the investment becoming impaired.

16 In EFRAG's view, although the introduction of two more measurement bases (transition date fair value and transition date previous GAAP amount) is not ideal for users, it will enable more entities to adopt IFRSs in the separate financial statements which ought in many cases to result in a general improvement in the understandability of their financial statements. The treatment of dividends from such investments will be different from before, but EFRAG believes in many ways it will be more understandable because of the shift in focus away from a pre- and post-acquisition reserves approach to an income and impairment approach.

Measurement of cost in the separate financial statements of a new parent

17 When a group reorganisation of the type described in the Amendments is undertaken, nothing of substance has happened. In such circumstances, one

would not expect there to be an accounting effect. As that will be the result under the Amendments, EFRAG believes the Amendment relating to group reorganisations is understandable.

Relevance and reliability

18 The effect of the Amendments is:

(a) to allow other bases to be used in the separate financial statements of an investor when measuring investments in subsidiaries, jointly controlled entities and associates on transitioning to IFRS;

(b) to recognise all dividends received from investments in subsidiaries, jointly controlled entities and associates as income without considering whether the dividend is paid out of pre-acquisition or post-acquisition accumulated profits. In some cases this make it more likely that an impairment loss will need to be recognised;

(c) to clarify how certain types of group reorganisation should be accounted for.

19 EFRAG has considered the effect that these changes might have on the relevance of the information provided.

(a) IAS 27 requires investments in subsidiaries, jointly controlled entities and associates to be measured at cost or fair value. It would appear to follow from this that other measurement bases—in other words, the measurement bases that, as a result of the Amendments, are allowed when transitioning to IFRS—are considered to be less relevant. On the other hand, this amendment (together with the one described in paragraph 18(b) above) makes it possible for more entities to adopt IFRS in their separate financial statements. EFRAG believes that this will result in a general improvement in the relevance of the financial statements involved.

(b) Although the change described in paragraph 18(b) above is a different way of accounting for dividends, EFRAG's assessment is that it will not result in less relevant information and could result in an improvement in the relevance of the information provided.

(c) In EFRAG's view, the effect described in paragraph 18(c) above has no implications for the relevance of the information provided; it is a clarification of an existing requirement.

20 EFRAG has also considered the effect that the changes described in paragraph 18 might have on the reliability of the information provided.

(a) EFRAG believes that the amendment described in paragraph 18(a) above is likely to have the effect of improving the reliability of the measures used, because for some entities wishing to transition to IFRS but not currently measuring their investments in subsidiaries, jointly controlled entities and associates at cost it was previously difficult to estimate that cost amount. On the other hand, some of the measurement bases now allowed will not

always represent a good proxy for cost, so it could be argued that this might affect the representational faithfulness of the information provided. However, EFRAG disagrees with this argument; the measurement basis used is required to be disclosed, so in EFRAG's view the issue of whether the measurement basis used is a faithful representation of cost does not arise—the measure is a faithful representation of the measure it purports to be.

(b) EFRAG's assessment is that the change described in paragraph 18(b) above will not have a significant effect on the reliability of the information provided. It is a different way of representing the dividends received from investments, but does not raise any reliability issues.

(c) In EFRAG's view, the effect described in paragraph 18(c) above will for many entities have no implications for the reliability of the information they provide, because it will merely confirm their interpretation of existing standards. For entities that will have to change their accounting, EFRAG believes it will involve using a measure that is easier to estimate and therefore likely to be more reliable.

Conclusion

21 For the above reasons, EFRAG has concluded that the Amendments are likely to result in an improvement in the information provided.

Does the accounting that results from the application of the Amendments meet the criteria for EU endorsement?

22 EFRAG has considered whether it believes that the Amendments meet the requirements of the European Parliament and of the Council on the application of international accounting standards, in other words that the Amendments:

(a) are not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG has also considered whether it is in the European interest to adopt the Amendments.

23 As explained above, EFRAG has concluded that the Amendments are consistent with the Framework and are likely also to result in an improvement in the information provided. In particular, EFRAG has concluded that the Amendments meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

24 EFRAG has also concluded that there is no reason to believe that the information resulting from the application of the Amendments would be contrary

to the true and fair view principle or that it would not be in the European interest to adopt them.

Conclusion

25 For the reasons set out above, EFRAG has concluded that the Amendments satisfy the criteria for EU endorsement and that EFRAG should recommend their endorsement.