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Re: ***EFRAG draft comment letter on Exposure Draft Improvements to IFRSs 2009***

Dear Sir/Madam

We are pleased to provide EFRAG with our comments in order to contribute to the finalization of the EFRAG comment letter on the IASB Exposure Draft *"Improvements to IFRSs 2009"*.
The ED deals with a number of relevant accounting issues, many of which were raised to IFRIC for interpretation in 2009. One of them regards the impairment of subsidiaries, joint venture or associates when they are carried at cost in the separate financial statements of the parent. As you might know, accounting for such investments in the separate financial statements burdens the Italian preparers, since the adoption of IFRSs in separate accounts is mandatory for the quoted entities, because of the lack of guidance in IAS 27. Consequently, changes in accounting treatment that affect separate accounts are relevant in Italy and therefore should be addressed with due attention. For these reasons, we comment on issue 10 (impairment of the investments in subsidiaries, joint ventures and associates in the separate financial statements) as a first priority and then all the others.

Regarding the amendment of IAS 27 proposed by the IASB, the main comments can be summarized as follows:

1. OIC welcomes the IASB initiatives to address a specific standard regarding the separate financial statements, as it is considered an area of the IFRSs that need a number of improvements;
2. Any project on the separate financial statements should start from the definition of their purposes. Such a definition should address any difference in purposes between consolidated and separate accounts;
3. It does not seem that the improvement project is the correct way to reach such an objective. The improvement project should clarify the aspects that result in difficult application of IFRSs and not change the rationale of accounting standards. This is not the case of the proposed amendment. It introduces amendments that are not consistent with the current requirements about the impairment of investment in subsidiaries, joint ventures and associates when they are carried at cost.
4. The introduction of an impairment model based on the requirements of IAS 39 for investments carried at cost, would create lot of significant issues for preparers and

would not improve the quality of the information. Entities will perform two different impairment tests for the same investment. They could reach different results that would not be clearly understandable by the users. It does not improve the information given;

5. The change in wording for the initial recognition of the investments in subsidiaries, joint venture and associates, could bring to an unintended effect, such as applying IAS 39 in its entirety to such investments, even if they are accounted for with the cost method. We suggest reviewing the wording of the amendment and its undesirable implications.

Detailed comments on Issue 10 “investment in subsidiaries, joint ventures and associates”

In order to illustrate the OIC’s position on this issue, it is critical to clarify the role that the separate financial statements play within the IFRS. Even if it is not clearly stated in the framework, we believe that its objective of the separate financial statements could differ from the the purpose of the consolidated financial statements. Obviously, it gives some information to the users, that perhaps are not the same of the consolidated accounts. The users of the separate financial statements might be interested in the information that is not presented in the consolidated accounts. They would be informed about the respect of the capital requirements, the taxable profit, and, of course, about the amount of the assets that legally guarantee the creditors.

It is a matter of fact that in the countries where the use of the IFRS has been allowed in the separate accounts of the parent company, they were forcedly introduced into a context that is not completely suitable to them. In such circumstances, it is necessary to recognize that the purpose of the separate financial statements can cause a difference in accounting principle then the consolidated accounts. Such a difference is justified by the specific purpose of the separate financial statements.

For these reasons, we strongly welcome the initiatives that the IASB takes to deal with the development of an accounting standard for the separate accounts, as it would represent an opportunity to eliminate some grey areas of the IFRSs. A project for improving the accounting standards applicable to the separate financial statements should define the decision-useful information for users given by the separate accounts, in the light of the different purposes with respect to the consolidated accounts. However, any other approach to improving the present few paragraphs dealing with the accounting provisions to be applied in separate financial statements for subsidiaries, joint venture and associates, it would be, in our opinion, incorrect. Bearing this in mind, it seems that the IASB is not working along these lines. On the contrary, the IASB is approaching the issue with the aim of clarifying some requirements that are not currently well explained by IAS 27, and in the meantime some argue that it is introducing some new aspects regarding the initial recognition of the investments in subsidiaries, joint venture and associates, that were not requested by the stakeholder that raised the issue to the IFRIC in May 2009.

Having said that, we think it is important to define the boundaries of the improvement projects. In our opinion, the improvement projects should provide the stakeholders with clarification of the application of the existing standards, rather than changing the accounting principles that underlie the standards.
This is not the case. We think that there are a number of clarifications needed in the impairment of the investments in, but they do not relate to the standard applicable. We believe IAS 36 currently applies to the impairment test of such investments. An impairment of an investment in a subsidiary cannot be compared with the impairment of another investment in equity instruments. We think that the guidance needed is related to the reconciliation between the IAS 36 impairment of the investments in subsidiaries, joint venture and associates with the impairment of those investments in the consolidated accounts. Even part

of the IASB Staff currently has the same view as us[1]. In analysing the current cost exception for unquoted equity instruments, they noted that currently paragraph 4 of IAS 36 applies to the impairment of investment in subsidiaries, joint venture and associates. Such conclusion has been confirmed by the recent amendment issued in May 2008. In that circumstance, the Board concluded that "*to reduce the risk that removing the definition of the cost method would lead to investments in subsidiaries, jointly controlled entities and associates being overstated in the separate financial statements of the investor, the Board proposed that the related investment should be tested for impairment in accordance with IAS 36*"[2]. Were it correct, the improvement project would seem to lose its role of clarification (alias, "improvements") and become a change in accounting standard. The amendment of IAS 27 will not clarify the rational why it is replaced the reference to IAS 36 for the impairment test of the investments when accounted for with the cost method in the separate financial statements. Rather it will change the impairment measurement from the IAS 36 to IAS 39. It is not clear to us if this change is the consequence of an insufficiently thorough analysis of the issue. However, we believe that this approach is not the correct way to deal with this issue.

From a purely technical point of view, the ED introduces two main changes to the current version of the IAS 27. One is related to the impairment of the investments of subsidiaries, joint venture and associates when they are carried at cost, and the other regards the initial recognition. Below, we analyse them separately.

Impairment of investments in subsidiaries, joint venture and associates

The ED requires that a parent that adopts the cost method in accounting for its investment in a subsidiary, joint venture or associate, shall perform the impairment test based on the requirements of IAS 39 for the impairment of equity instruments.
Based on our acknowledge of the present practice, entities that are required to prepare separate accounts in accordance with IFRS mostly measure their investments in subsidiaries, joint venture and associates at cost.

The ED will have several negative consequences on the entities that account for at cost. Differentiating the impairment models between the consolidated and the separate financial statements gives rise to possible unjustified effects between the two sets of accounts. This also means that entities will have to perform two separate calculations:

- at least methodology-wise, because the impairment models are different under the two standards. In fact, on the basis of IAS 39, impairment on equity instruments is fair-value based, while under IAS 36 the recoverable amount is estimated by referring to the value in use of the CGU. Hence, an entity could record an impairment in the separate financial statements by following IAS 39 but not in the consolidated financial statements as the value in use could exceed the fair value. A possible economic effect of such a difference could bring to a limitation in the distribution of dividends, due to losses from impairment that the consolidated financial statements do not recognize. Usually, the adoption of the cost method leads to an opposite conclusion, as under the cost method, gains or losses based only on market changes are recognized only when they are realized or in presence of a loss impairment;

- the unit of account may differ. Under the proposed amendment, the entity will have to test the carrying amount of the legal entity for IAS 39 purposes, while the same legal entity may include multiple CGU or be part of a greater CGU at group level. It is not clear how those two impairment tests made at different level reconcile.

[1] See para 26 Staff paper 4 *Exemption from fair value measurement for some unquoted equity instruments – replacement of IAS 39* meeting 29 September 2009.
[2] Please refer to IAS 27 BC66I.

Furthermore, we believe that since the IASB board is currently discussing how to change the impairment requirements in IAS 39, the implications of the proposed improvement are unclear. For that reason, we believe that the improvement should be delayed at least until after the revision of IAS 39 will be completed.

The initial recognition of the investments in subsidiaries, JVs or associates.

The ED proposes a change in the wording of the initial recognition of the investments in subsidiaries, JVs or associates. Under the proposed amendment, an entity could apply either the cost method or the fair value through profit or loss, each in accordance with IAS 39.
Unfortunately, it is not clearly stated in IAS 39 what an entity should mean by cost. It could lead to 2 different conclusions:

1. Were the aim of the Board to apply only IAS 39 in its entirety to the investments in subsidiaries, joint venture and associates, entities would not be able to use cost unless they proved that the fair value were not reliably determinable (par 47 (c) of IAS 39). Since a parent is normally able to access information on forecasts and expected cash flows of a subsidiary or the subsidiary is quoted in a market, in substance the amendment would prevent in most cases the use of cost for an investment in a subsidiary. If this is the desired result, this seems in contrast with IAS 27. The Board argues that the reason for the amendment is that in the separate statements the focus is on the performance of the assets as investments. Assuming that this is appropriate, we note that IAS 27 BC66[3] specifically admits that using either the fair value in accordance with IAS 39 or the cost method would be relevant, and that the relevance of the information would depend on the purpose of preparing the separate financial statements. So, preventing the use of cost is a fundamental change to IAS 27. Even when entities apply IAS 39, it is unclear why under the current rules of IAS 39 entities should be required to classify those investments in the FVTPL category, which as matter of fact does not require impairment. This category is customarily used for investments held for trading. Investments in subsidiaries and associates often are of a strategic type and intended for long-term holding. It is unclear why inclusion in the FVTPL would generate more useful information since the intent of the investment is not to generate short-term disposal gains, as investment returns. In light of these reasons, we do not agree with the proposed change, also considering the general comments illustrated above.

2. If the intention of the Board were to retain the current free choice in applying the cost method rather than the fair value method, the referral to the meaning of cost for an equity instrument in IAS 39 is not appropriate . As said above, IAS 39 does not include a definition of the cost for equity instruments and therefore there is a serious risk that some could interpret the proposal wording as all investments in subsidiaries, joint ventures and associates should be always measured at fair value (both quoted and unquoted instruments even if the intention of entity is to apply the cost method for such investments). In this case we would appreciate that the Board modify the wording of the proposed amendment, retaining the current free option to account for investments in subsidiaries, joint venture and associates at cost or fair value. The IASB could consider maintaining the present accounting and reinstating par. 38 of IAS 27 as follows:

[3] BC 66 IAS 27: *"Although the equity method would provide users with some profit and loss information similar to that obtained from consolidation, the Board noted that such information is reflected in the investor's economic entity financial statements and does not need to be provided to the users of its separate financial statements. For separate statements, the focus is upon the performance of the assets as investments. The Board concluded that separate financial statements prepared using either the fair value method in accordance with IAS 39 or the cost method would be relevant. Using the fair value method in accordance with IAS 39 would provide a measure of the economic value of the investments. Using the cost method can result in relevant information, depending on the purpose of preparing the separate financial statements. For example, they may be needed only by particular parties to determine the dividend income from subsidiaries".*

"*When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:*

(a) at cost, or

(b) at fair value in accordance with IAS 39[4]*.*"

In order to clarify the meaning of the cost, the Board could introduce a definition of the cost of such an investment. The definition of paragraph 100 (a) of the framework regarding the notion of "historical cost", could be considered.[5]

GENERAL COMMENTS on other issues within the improvement project.

Regarding the other issues described by the ED, we agree with all the EFRAG's comments, except for:

- Issue 8 – IAS 1 *Presentation of Financial Statements: Clarification of statement of changes in equity*. The Board proposes to clarify that entities are permitted to present the reconciliation requirements for classes of accumulated other comprehensive income either in the statement of changes in equity or in the notes to the financial statements. We do not agree with the IASB proposal. We believe that an entity should be required to present the reconciliation for classes of accumulated other comprehensive income in the statement of changes in equity in any case;

- Issue 14 – IAS 40 *Investment Property: Change from fair value model to cost model*. The Board proposes to remove the requirement to transfer investment property carried at fair value to inventory when it will be developed for sale, to add a requirement for investment property held for sale to be displayed as a separate category in the statement of financial position and to require disclosures consistent with IFRS 5. We do not agree with the IASB proposal. Moreover, we note that the amendment is inconsistent with the IAS 16 (par. 68 A) that states that "*IFRS 5 does not apply when assets that are held for sale in the ordinary course of business are transferred to inventories*".

A few other concerns relate to the following:

- Issue 4 – IFRS 3 *Business Combinations: Measurement of non-controlling interests*. The Board proposes to amend paragraph 19 of IFRS 3 to clarify that the choice of measuring non-controlling interest either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets applies only to instruments that are currently entitled to a proportionate share of the acquiree's net assets. Other instruments that meet the definition of non-controlling interest should be measured at fair value or in accordance with applicable IFRSs. We agree with the EFRAG's view. However, we recommend that the IASB provide some examples to clarify better the issue. We also believe that an implementation guidance that explain the meaning of *"holders to a pro rata share of the entity's net assets in the event of liquidation"* should be added in IAS 32 and not in IFRS 3 and that it should be reconciled with the guidance in IAS 27.

- Issue 12 – IAS 28 *Investments in Associates: Partial use of fair value for measurement of associates*. The Board proposes to amend IAS 28 to clarify that different measurement bases can be applied to portions of an investment in an associate when part of the investment is designated at initial recognition as at fair value through profit or loss in accordance with the scope exception in paragraph 1 of IAS 28. We agree with the

[4] A similar wording was proposed by the IASB Staff in the agenda paper 13B for the IASB board meeting in June 2009.

[5] *Historical cost*. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

EFRAG's view. However, we notice that there is an inconsistency between this issue and Issue 6 – IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations: Application of IFRS 5 to loss of significant influence over an associate or a jointly controlled entity*. In fact, in the Issue 6 the Board proposes to clarify that an entity classifies as held for sale its interest in an associate or a jointly controlled entity when it is committed to a sale plan involving loss of significant influence or joint control. So, in order to solve the inconsistency we believe that the IASB should address the definition of *"unit of account"*.

- Issue 15 – IFRIC 13 *Customer Loyalty Programmes: Fair value of award credit*. The Board proposes to amend IFRIC 13 to clarify the meaning of the term "fair value". We agree with the EFRAG's view. We believe that it is only an amendment about the wording in IFRIC 13. Accordingly, we recommend to the IASB that an entity should apply this amendment to the financial statements of 31/12/2009.

If you have any questions concerning our comments, please do not hesitate to contact us.

Yours sincerely,

Angelo Casò
(Chairman)