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International
Accounting Standards
Board

This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.

Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: March 2006, London

Project: **IFRS 1 *First-time Adoption of International Financial Reporting Standards* - Cost of a subsidiary in the separate financial statements of a parent (Agenda Paper 6)**

Introduction

1. The IFRIC was asked to consider two issues regarding the accounting for investments in subsidiaries on adoption of IFRS 1 *First-time Adoption of International Financial Reporting Standards* in the separate financial statements of a parent. These issues are applicable only to the separate financial statements of the parent.

Issue 1 – How to determine the cost of an investment in a subsidiary in the separate financial statements of the parent entity upon its transition to IFRS?

2. The correspondents believe that there would be significant difficulty and cost involved if the cost of investments in subsidiaries is re-measured in accordance with IAS 27, for those investments undertaken by a parent before its adoption of IFRSs. Although IFRS 1 gives exemptions to first-time adopters of IFRSs from applying IFRS 3 *Business Combinations* retrospectively to past business combinations that occurred before the date of transition to IFRSs, there is no equivalent relief for a parent entity in its first IFRS separate financial statements from applying the requirements of IAS 27 for recognising the cost of its investment in subsidiaries.
3. This matter has been highlighted by the use of merger relief accounting in the United Kingdom and other countries. Under merger relief accounting, any shares provided as

consideration for the purchase of an investment in a subsidiary are recorded (for the purposes of cost) at their nominal value.¹

Issue 2 – What is the dividing line for pre- and post-acquisition reserves of a subsidiary for the purposes of determining the carrying amount of the investment in a subsidiary in the parent entity’s first IFRS separate financial statements?

4. Under IAS 27, there is a requirement to assess dividends as pre- or post- acquisition. Only post-acquisition dividends from a subsidiary are recognised as income in the separate financial statements of the parent entity. Dividends from pre-acquisition profits are recognised as a recovery of the investment. IAS 27 requires cost to be stated initially at the amount of consideration paid. This cost will be adjusted over time by any dividends paid out of pre-acquisition reserves and by impairments.
5. In some jurisdictions, entities recognise dividends as revenue in the separate financial statements of the parent even if those dividends have been paid out of pre-acquisition profits. In these cases, the cost of an investment in a subsidiary is only written down when the payment of a dividend results in an impairment.
6. Unless an exemption is given, application of IAS 27 by first-time adopters of IFRS would require reconstruction of the costs of investment in subsidiaries both in respect of dividends paid out of pre-acquisition reserves but not deducted from cost and in respect of every other difference between IFRS and the accounting policies applied in determining the costs of investment in subsidiaries. This task would be nearly impossible for many companies with a long history of acquisitions.

Summary of discussions at Agenda Committee meetings

7. These issues have been discussed at the IFRIC Agenda Committee meetings in September 2005 and January 2006. Two possible sources of relief from restating the cost of the investment under IAS 27 upon initial adoption of IFRS have been discussed (being the exemption from reopening business combinations and the exemption from keeping parallel records). As a result of these meetings, the staff was asked to perform further analysis as to the most appropriate resolution of this issue. This analysis has been reproduced in the Appendix.
8. At the February 2006 IFRIC Agenda Committee meeting, the committee agreed with the staff that an amendment should be made to IFRS 1 in respect of IAS 27. The Agenda Committee recommended that the issue should not be taken onto the IFRIC

¹ For example, if Entity A purchased 100% of Entity B by providing 100,000 £1 shares to the shareholders of Entity B as consideration, the investment would be recorded as £100,000 in the separate financial statements of Entity A. This is regardless of the fair value of those shares.

agenda. The Agenda Committee also agreed that they should not consider the issue of how to amend IFRS 1 as this would not assist the Board in its process.

Recommendation

9. The staff believe that the treatment of investments in subsidiaries in the separate financial statements of the parent has not been addressed satisfactorily in IFRS 1. The intention of the exemption available for restating business combinations was to discourage the recreation of data that was not collected at the time of the transaction. Compelling entities to re-visit every pre-transition cost of investment and pre-acquisition reserves calculation is inconsistent with the principles in IFRS 1.
10. The Agenda Committee believed that this issue could not be resolved by an Interpretation. The staff, therefore, will ask the Board to make amendments to IFRS 1.

Appendix - Analysis of the possibility of resolving the issue by interpretation as presented to the IFRIC Agenda Committee

- 1) IFRS 1 provides first-time adopters with an exemption from having to apply IFRS 3 retrospectively to past business combinations. Without this exemption, the adoption of IFRSs 'could require an entity to recreate data that it did not capture at the date of a past business combination and make subjective estimates about conditions that existed at that date. These factors could reduce the relevance and reliability of the entity's first IFRS financial statements'.² However, in the absence of a reference to IAS 27 in IFRS 1, it is difficult to make a case that this exemption should be applied to the separate financial statements of the parent.
- 2) The calculation of cost for a business combination is similar to the calculation of the cost of the investment in a subsidiary. It is inconsistent to exempt an entity from reopening a business combination whilst requiring a reconstruction of the cost of an investment upon first time adoption.
- 3) The calculation of cost under IAS 27 requires an investor to allocate dividends received from the subsidiary as pre- or post-acquisition. Any pre-acquisition dividends are required to be deducted from cost. If IFRS 1 is applied in its current form, correspondents argue that there will be a significant cost to industry in applying IAS 27 as items such as cost and pre-acquisition reserves will need to be restated. Further, correspondents argue that the information required for restating amounts might not be available.
- 4) This can be illustrated using the example of merger relief accounting. Pre-transition to IFRS, assume Entity A purchases 100% of Entity B's share capital for £100,000 (comprised of 10,000 shares with a fair value of £10 and a nominal value of £1). Entity A elects to use merger relief in accounting for entity B. The cost recorded in the separate financial statements of Entity A would be £10,000.
- 5) Upon transition to IFRS, Entity A would be required to restate cost to ensure compliance with IAS 27. This would involve re-measuring the consideration received (which in this case would be £100,000) and then adjusting for any dividends that had been received from pre-acquisition reserves. This would be difficult to assess as pre-acquisition reserves would presumably need to be restated under IFRSs, which would involve making the same types of judgements that IFRS 1 provides relief from for business combinations.

² IFRS 1 BC 32

Does IFRS 1 provide relief from restating the cost of investment in a subsidiary in accordance with IAS 27 on first time adoption?

Exemption for business combinations

- 6) **IFRS 1 does not explicitly specify any exemptions to applying either the cost method or IAS 39 to investments in subsidiaries in the separate financial statements of the parent on transition to IFRS.**
- 7) IFRS 1 states that ‘a first time adopter may elect not to apply IFRS 3 *Business Combinations* retrospectively to past business combinations (business combinations before the date of transition to IFRS).³
- 8) There is a direct link between the cost of a business combination and the cost for the purposes of IAS 27. The two amounts are the same on initial recognition of a combination / purchase. It should follow therefore that any exemption on first time adoption would apply to both as the difficulty in recreating a past combination would extend to a past acquisition.
- 9) If the exemption provided to business combinations could be extended (via interpretation) to the separate financial statements of the parent (in that exempting cost under a business combination would also exempt cost under IAS 27 on first time adoption), it would resolve any concerns held by correspondents. The carrying amount of a subsidiary could be carried forward at its pre-IFRS amount and subject to impairment tests upon first time adoption.
- 10) However, the definition of a business combination under IFRS 3 involves the combination of a ‘business’. In the separate financial statements of a parent, an investment in a subsidiary is not accounted for as a business combination but as an investment. Hence, the link between the exemption provided to the cost of business combinations under IFRS 3 and cost under IAS 27 is tenuous.
- 11) Given the above, under the current IFRS 1, the carrying amount of investments in subsidiaries (and joint ventures and investment in associates) in the separate financial statements of the parent, will need to be restated to cost or fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.⁴ This would also apply to joint ventures and investments in associates.⁵

³ IFRS 1 Appendix B – B1.

⁴ As required by IAS 27 (37).

⁵ The exemption in relation to joint ventures and associates in Appendix B of IFRS 1 was only in relation to the business combination.

Parallel records

- 12) One exemption also explored by staff relates to the relief from having to maintain parallel records. IFRS 1 provides an exemption designed to stop an entity having to keep parallel sets of records. For example, IFRS 1 paragraph 24 allows a subsidiary to elect to use, in its separate financial statements, the carrying amounts used in the parent's consolidated financial statements (assuming the parent had already transitioned to IFRSs) or those required by IFRSs.
- 13) When an entity adopts IFRSs for the first time, it will consolidate the underlying assets and liabilities of its subsidiaries. This may involve (depending on whether the subsidiary has previously reported under IFRS) adjusting the underlying assets and liabilities to IFRSs. Paragraph 25 states:

If a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.
- 14) Paragraph 25 requires that the same values be used in the separate financial statements of the parent as in the group financial statements. An investment in a subsidiary initially comprises the underlying assets and liabilities. On consolidation there could be a difference between the cost of the investment in the separate financial statements of the parent and the cost of the business combination for the purpose of consolidation of the subsidiary in the group financial statements. This is due to items affecting the cost of the investment in the separate financial statements of the parent such as impairments and pre-acquisition dividends.
- 15) However, the principle in this exemption also provides a basis for considering measuring the cost of the investment in the separate financial statements of the parent in line with the underlying assets and liabilities on first time adoption. Using this principle, the parent could potentially report a 'cost' based on a rolling up of its net investment (the underlying assets and liabilities) in the subsidiary at the date of transition to IFRS. This would be a similar treatment on first time adoption as provided for the deemed cost of property, plant and equipment.