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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **21 July 2006, London**

Project: **Cost of an investment in a subsidiary in the separate financial statements of a parent on first time adoption of IFRSs (Agenda Paper 16)**

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1. At the May 2006 meeting, the staff presented several alternative methods of relief from restating the cost of an investment in a subsidiary in accordance with IAS 27 *Consolidated and Separate Financial Statements* on first time adoption of IFRSs.

2. At that meeting, the Board directed the staff to analyse one of those methods further. The purpose of this paper is present the results of this analysis.

Staff Recommendation

3. The staff recommends:

- that IFRS 1 *First Time Adoption of International Financial Reporting Standards* be amended to allow a parent to use the carrying amount of the net assets of a subsidiary (in accordance with IFRSs) at the date of the parent's transition to IFRSs as a deemed cost for the investment in the subsidiary in the separate financial statements of the parent.

- that, if a parent applies the relief from restating the cost of an investment on transition to IFRSs, the accumulated profits of the subsidiary at that date are deemed to be pre-acquisition profits for the purposes of the cost method in IAS 27.

COST OF AN INVESTMENT IN A SUBSIDIARY ON TRANSITION TO IFRSs

Background

4. Constituents argue that, in some circumstances, it is difficult to measure the cost of an investment in a subsidiary in accordance with IAS 27 *Consolidated and Separate Financial Statements* on first time adoption of IFRSs.

5. Some entities adopting IFRSs may have measured the cost of an investment in a subsidiary under their previous GAAP in a manner that is not in accordance with IAS 27.

6. Constituents have highlighted difficulties measuring the cost of an investment in a subsidiary that arise in situations when the value of the consideration paid can only be determined with reference to the value of the entity acquired. For example, if an entity issues unlisted shares to obtain 100% of the share capital of another entity, the value of the consideration would be determined with reference to the value of the acquired entity.

7. In these circumstances, when a method of accounting other than the purchase method in accordance with IFRS 3 *Business Combinations* has been used under national GAAP, a parent would have to reconstruct the business combination using the purchase method in order to determine cost on adoption of IFRSs.

8. In addition to measuring the initial purchase of a subsidiary at cost, constituents have highlighted difficulties in determining the cost of an investment in a subsidiary on first time adoption when dividends have been paid since acquisition. IAS 27 requires that post-acquisition 'dividends' be assessed as to whether they relate to pre- or post- acquisition profits. Under IAS 27, a dividend out of pre-acquisition profits is credited to the investment in the subsidiary and not treated as income.

9. In some jurisdictions, prior to the transition to IFRSs, there was no requirement to assess whether dividends were paid out of pre- or post-acquisition profits. In these jurisdictions, at the date of transition, parent entities will need to reassess every distribution received from their subsidiaries to determine whether they were income or a return of capital (and hence deducted from the cost of the investment in the subsidiary).

10. At its March 2006 meeting, the Board added a project to its technical agenda to resolve issues relating to measuring the cost of an investment in a subsidiary in the separate financial statements of a parent on first time adoption of IFRSs.

11. Subsequently, at the May 2006 meeting, the Board directed the staff to analyse a potential method of relief from the requirement to restate the cost of the investment in a subsidiary in accordance with IAS 27. The proposed relief permits a parent to use a deemed cost for its investments in subsidiaries instead of restating cost in accordance with IAS 27. This deemed cost is to be calculated by reference to the underlying carrying amount of the net assets of the subsidiary.[1]

[1] Reference to the net assets of the subsidiary is defined as the IFRS-compliant statement of financial position of the subsidiary (or IFRS-compliant consolidated statement of financial position of its group if the subsidiary itself has subsidiaries). It does not include any push down accounting of goodwill that occurs under some other GAAPs.

Staff Analysis

12. When an entity is unable to restate the cost of an investment in a subsidiary on first time adoption of IFRSs, the staff believe that the most appropriate form of relief would be to allow a parent to align the carrying amount of an investment in a subsidiary with its IFRSs-compliant net asset position at the date of transition.[2] This relief would be provided by way of an exemption in IFRS.

More useful information

13. The proposed relief provides users with information that is reflective of the financial <u>position</u> of the subsidiary at the date of transition. By aligning the cost of the investment in a subsidiary with its underlying net asset position, users will be able to identify the IFRSs' net asset position of the subsidiary to which the investment relates. This would assist users by providing relevant information about the financial position of the subsidiary.

Ease of application

14. Initially, the staff believed that the proposed relief was easy to apply as the information required was readily available (since it was necessary in order to prepare the consolidated financial statements). However, constituents suggest that there would be significant effort in preparing sub-group consolidations to determine the underlying net asset position of a subsidiary at the date of transition. The staff acknowledge that there is an additional burden in some circumstances; however, the task of preparing sub-group consolidations would not be impossible.

[2] The 'date of transition' refers to the parent's date of transition to IFRSs.

Other options considered

15. An option previously considered by the staff was to use the cost amount from the previous national GAAP as a deemed cost on transition. However, the information provided by this method was not considered suitable in some circumstances. For example, in situations where merger relief has been used, the cost under previous national GAAP represents a nominal value relating to the number of shares issued as consideration for the acquisition of a subsidiary. This value holds little information value to users.

16. A further option considered by the staff was to allow a parent entity to use a deemed cost based on the fair value of the subsidiary as it would provide information about the underlying market value of that subsidiary. The staff believe that this information would be more useful to users than historical cost or restated cost amounts based on net assets of the subsidiary as the information represents a measure of the economic value of the investment. However, the associated costs (staff time, external resources required) and difficulties (valuation complexities, re-creation of data, subjective estimations) of applying this measure may outweigh the expected benefits.

Staff recommendation

17. Using a deemed cost based on the previous national GAAP cost would be the most straightforward option to apply as the deemed cost value would be the same as that used prior to a parent's transition to IFRSs. However, the relevance of this value may be reduced as it may be based on a nominal amount or other value that is not compliant with the measurement bases in IAS 27 (historical cost, fair value). Conversely, using a deemed cost based fair value would provide current market based information but may be costly and difficult (as discussed in paragraph 16). By aligning the cost of investment with its underlying net asset position, the staff believe that understandable and reliable information is provided with (relatively) minor difficulty.

18. Accordingly, the staff recommend that IFRS 1 *First Time Adoption of International Financial Reporting Standards* be amended to allow a parent to use the carrying amount of the net assets of a subsidiary (in accordance with

IFRSs) at the date of the parent's transition to IFRSs as a deemed cost for the investment in the subsidiary in the separate financial statements of the parent.

19. **Does the Board agree?**

POST-TRANSITION DISTRIBUTIONS

20. This section discusses an issue that is related to the relief from restating the cost of investment of a subsidiary. However, it is not a continuation of the previous discussion.

Background

21. If an entity applied the proposed relief (which allows for a subsidiary to be carried at a deemed cost equivalent to its carrying amount of net assets) there would nevertheless be difficulty in determining whether the distributions from a subsidiary that were received by the parent after adopting IFRSs were income or a return of the original investment.

Difficulties in determining whether distributions are from the pre- or post-acquisition accumulated profits of a subsidiary after a parents has adopted IFRSs

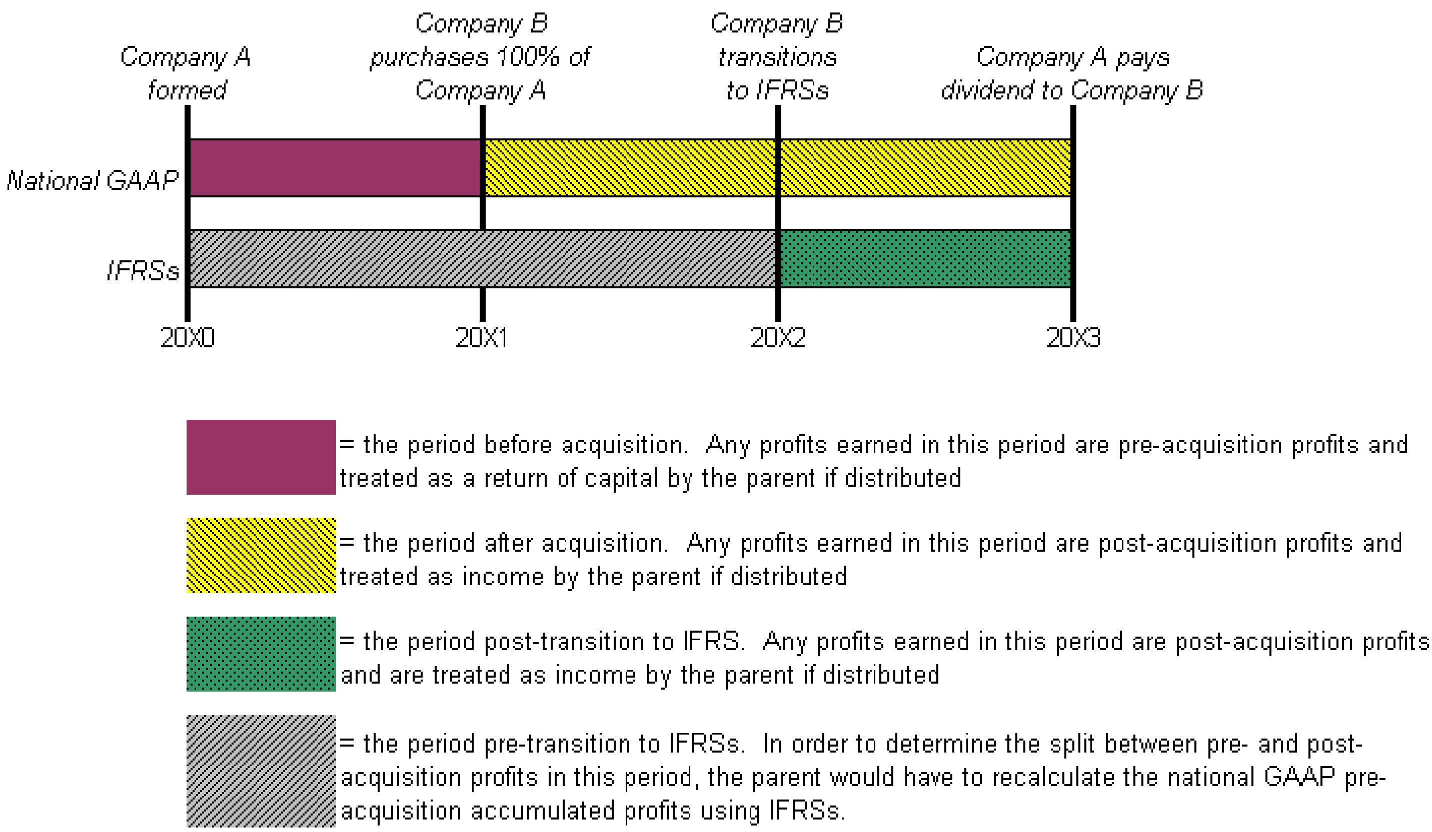
22. Parent entities that adopt IFRSs will need to comply with the requirements of IAS 27 when accounting for distributions they receive from subsidiaries. The <u>cost method</u> in IAS 27 paragraph 4 states that an 'investor recognises income from the investment only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition. <u>Distributions in excess of such profits are regarded as a recovery of the investment and are recognised as a reduction of the cost of the investment</u> (emphasis added)'.

23. In order to determine how to treat distributions received from a subsidiary, the parent entity needs to know the accumulated profits of the subsidiary earned before the subsidiary was acquired (the pre-acquisition profits).

24. Subsidiaries that were acquired prior to their parent's transition to IFRSs would (in most cases) have their pre- (and post-) acquisition profits calculated using the previous national GAAP. Once a parent has adopted IFRSs, these

profits would need to be recalculated in accordance with IFRSs. This is required in order for a parent to comply with the requirements of IAS 27.4 when a distribution has been received from a subsidiary (ie to determine which distributions had been received from pre- or post-acquisition profits).

25. Consider the following scenario in relation to Company A and Company B. Company A was formed in 20XO and purchased by Company B in 20X1. In 20X2, Company B adopted IFRSs for the first time. At this stage it restated its statement of financial position and the statement of financial position of Company A. An IFRSs transition adjustment was made that reduced Company A's accumulated profits at this time. In 20X3, Company A paid a dividend to Company B equivalent to its <u>entire</u> IFRS accumulated profits. In order to assess which parts of this distribution were income or a return of capital (as required by IAS 27.4), Company B would need to restate Company A's pre-acquisition accumulated profits in accordance with IFRSs. This scenario is represented by the diagram below.



26. Recalculating pre- and post-acquisition profits to be compliant with IFRSs would be a task tantamount to restating business combinations (for which

there is an exemption in IFRS 1). This is because a parent would need to recreate the IFRSs statement of financial position at the date of acquisition in order to determine pre-acquisition profits. This task may involve subjective, and potentially selective, use of hindsight that would diminish the relevance and reliability of the information. In many circumstances, this would be a time consuming and difficult process and in some cases it would be impossible (as it would involve making judgements about the fair values of the assets and liabilities of a subsidiary at the time of acquisition).

27. Due to the difficulties involved in recalculating these profits, the Board directed the staff to explore the impact of providing relief that removes the difficulties in determining the split between pre- and post-acquisition profits.[3]

Staff analysis

28. The staff explored various methods of relief from having to restate the pre- and post-acquisition profits of a subsidiary for the purposes of the cost method of IAS 27. The staff believe that the most effective method of relief would be to make an amendment to IFRS 1 that allowed a parent to deem the <u>pre-transition</u> profits of a subsidiary (as either pre-acquisition, post-acquisition or a combination of both) on transition to IFRSs for the purposes of applying IAS 27.[4] By providing relief in this manner, the application of IAS 27 would not be affected.[5]

Deeming pre- and post-acquisition profits on transition to IFRSs

29. On transition to IFRSs, the split (or dividing line) between pre- or post-acquisition accumulated profits could be determined with reference to a rule. The staff explored three rules that would alleviate the need to recalculate the pre- and post-acquisition profits of a subsidiary on transition to IFRSs. These were to:

- Deem all accumulated profits (ie IFRSs compliant profits) of a subsidiary at the date of transition to be <u>pre-acquisition</u>;

[3] This relief would only be available in respect of post-transition distributions from subsidiaries acquired prior to the parents transition to IFRSs.
[4] The date of transition refers to the parent's date of transition.
[5] The staff had considered changing the cost method in IAS 27. However, it was considered to be out of the scope of this project as it will be reviewed as part of the consolidations project.

- Deem all accumulated profits (ie IFRSs compliant profits) of a subsidiary at the date of transition to be post-acquisition; and
- Roll over the pre-acquisition profits from the previous national GAAP on transition.[6]

[6] The difference between the IFRSs accumulated profits of the subsidiary and the pre-acquisition profits under national GAAP would be the post-acquisition profits.

Deem all accumulated profits of a subsidiary to be pre-acquisition on transition

30. Deeming the accumulated profits of a subsidiary as pre-acquisition on transition to IFRSs for the purposes the cost method in IAS 27 would be the equivalent of resetting the acquisition date of the subsidiary in line with the IFRSs transition date of the parent. The effect of this would be to treat any distributions received by a parent from a subsidiary's profits earned prior to the parent's transition to IFRSs as a return of capital and a credit to the cost of investment.

31. Whilst this initially seems punitive to any parent that has a subsidiary with accumulated profits earned prior to the transition to IFRSs, it needs to be considered in the broader context.[7]

32. When a parent applied the relief from restating the cost of the investment in accordance with IAS 27 (discussed in 'Cost of an investment in a subsidiary on transition to IFRSs' above in paragraphs 4-18) it will have aligned the cost of the investment in the subsidiary with the subsidiary's net asset position. In many cases, this will have resulted in an increase to the cost of the investment in the subsidiary.[8] This increase to the cost of the investment on transition will create a corresponding credit to the accumulated profits of the parent. The increase in accumulated profits of the parent would be equivalent (broadly) to the profits that were earned post-acquisition by the subsidiary (calculated in accordance with IFRSs) prior to its parent's transition to IFRSs.[9]

33. Following this, in some circumstances (such as when merger relief has been used), there may be a credit to retained earnings greater than the accumulated profits earned by a subsidiary after acquisition. This anomaly could only be resolved by using the previous national GAAP of a subsidiary as a deemed cost (as there would not be a credit to accumulated profits using this method). Where merger relief had been used, a parent was able to record distributions from the pre-acquisition accumulated profits of a subsidiary as income under national GAAP. [Sentence omitted in observer notes]. Therefore, whilst this

[7] This rule would prevent distributions from both pre- and post-acquisition accumulated profits earned by the subsidiary prior to the parents transition to IFRSs being treated as income

[8] Continued losses would already have resulted in a write-down of the cost of the investment under national GAAP in most cases.

[9] If all post-acquisition profits of the subsidiary had been distributed to the parent, the effect on the parent's accumulated profits would be similar.

issue is a concern, it is a concern that cannot be rectified on transition to IFRSs without restating cost in accordance with IAS 27.

34. Deeming the accumulated profits of a subsidiary to be pre-acquisition, for the purposes of the cost method in IAS 27, will prevent a parent entity from 'double counting' the profits of the subsidiary. To explain:

- In many cases a parent will recognise an increase to accumulated profits when the cost of the investment in a subsidiary is restated on transition (in accordance with the relief from restating the cost of the investment in a subsidiary in accordance with IAS 27).

- A further increase to accumulated profits would be recognised if a distribution received from the subsidiary's pre-transition accumulated profits were to be treated as income. In this scenario, the parent entity would recognise an increase to its accumulated profits twice as a result of the profits earned by a subsidiary post-acquisition but prior to the parent's transition to IFRSs.

35. By treating distributions received by a parent from a subsidiary's pre-transition accumulated profits as a return of capital instead of income, there is no effect on the statement of financial performance. However, the parent has the initial credit to accumulated profits resulting from the restatement of the cost of the investment available for distribution.

36. This rule is simple to apply and allows a parent to distribute the profits of its subsidiaries to its shareholders without recalculating the split between pre- and post-acquisition profits of the subsidiary. It also prevents potential 'double counting' of profits when a parent entity has applied the relief from restating the cost of the investment.

37. The significant disadvantage of this rule is that all distributions received by a subsidiary from pre-transition profits would be recorded as a return of capital in the separate financial statements of a parent. This may mask the true performance of the subsidiary in the statement of financial performance of the parent. However, other statements such as the cash flow statement will provide information relevant to users of the parent's financial statements.

Deem all accumulated profits of a subsidiary to be post-acquisition on transition

38. On transition to IFRSs, the accumulated profits of a subsidiary could be deemed to be post-acquisition for the purposes of the cost method in IAS 27. This would effectively require all distributions of a subsidiary to be treated as income in the separate financial statements of the parent.

39. This rule would be simple to apply and require minimal cost (staff resources) to implement. However, its major shortfall is that it would allow distributions paid out of what could be pre-acquisition accumulated profits (if the pre-acquisition accumulated profits of the subsidiary had been restated in accordance with IFRSs) to be treated as income in the statement of financial performance of the parent. The need to perform an impairment test on the cost of an investment in a subsidiary would ensure that distributions were not made in excess of the underlying value of the subsidiary.

40. Further, by treating all pre-transition accumulated profits as post-acquisition for the purposes of the cost method in IAS 27, a parent that uses this relief may be able to 'double count' the profits of the subsidiary (this issue is described in paragraph 34).

Roll over the pre-acquisition profits from the previous national GAAP on transition

41. The staff also considered the possibility of using the value of pre-acquisition accumulated profits from the previous national GAAP as the pre-acquisition profits amount in accordance with IFRSs for the purposes of the cost method in IAS 27. This would effectively roll over the pre-acquisition value from the previous national GAAP.

42. The rule would be simple to apply and have a minimal cost (staff resources) of implementation. Whilst the previous national GAAP pre-acquisition accumulated profits would not always be equivalent to the pre-acquisition accumulated profits calculated in accordance with IFRSs, they may be roughly aligned if the basic accrual accounting underlying the two GAAP's were similar.

43. However, as with the rule that would deem all pre-transition accumulated profits as post-acquisition (discussed above), this option may allow a parent to

recognise income from distributions received from a subsidiary's pre-acquisition IFRS-compliant accumulated profits.[10] Further, it may also allow a parent to 'double count' the profits of the subsidiary (this issue is described in paragraph 34).

Analysis of the proposed method

44. Of these potential rules, the staff believe that deeming all profits of a subsidiary as pre-acquisition at the date of the parent's transition to IFRSs would be the best option. This rule allows a parent to distribute the profits of its subsidiaries to its shareholders without recalculating the split between pre- and post-acquisition profits of the subsidiary. It also prevents potential 'double counting' of profits when a parent entity has applied the relief from restating the cost of the investment.

45. This was not the case with the two other potential rules (using the national GAAP pre-acquisition accumulated profits and deeming all accumulated profits to be post-acquisition). Each of these would have allowed a parent to record an increase in accumulated profits when applying the relief from restating cost, in addition to allowing pre-transition profits (or part of) to be recorded as income. It was for this reason that staff considered these rules were not suitable.

46. The staff recommend that, if a parent applies the relief from restating the cost of an investment on transition to IFRSs, the accumulated profits of the subsidiary at that date are deemed to be pre-acquisition profits for the purposes of the cost method in IAS 27.

47. **Does the Board agree?**

[10] As the pre-acquisition accumulated profits of the subsidiary had not been restated in accordance with IFRSs, distributions that are post-acquisition under national GAAP may, because of differences in timing of recognition under IFRSs, be made from the pre-acquisition accumulated profits of the subsidiary (calculated in accordance with IFRSs).