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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Agenda Proposal: IFRS 1 amendment for cost in the separate financial statements of the parent (Agenda Paper 15)**

Introduction

1. The purpose of this paper to recommend to the Board that it add a project to its technical agenda. The purpose of the project is to reduce the cost of complying with IFRS 1 for parent entities publishing separate financial statements in relation to measuring the cost of an investment in a subsidiary.

2. IFRS 1 requires investments in subsidiaries to be measured in accordance with IAS 27 at the date of transition to IFRSs. Constituents contend that they are faced with significant difficulty and cost in meeting this requirement.

3. *Issue 1 – Initial cost* – In some cases it is difficult to determine the initial cost of an investment in a subsidiary, in the separate financial statements of a parent, in accordance with IAS 27 when an entity adopts IFRSs for the first time. 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] This nominal value is not cost in accordance with IAS 27, which requires that the cost be stated initially at the amount of consideration paid.

4. *Issue 2 – Post acquisition dividends* - IAS 27 requires that the initial cost is adjusted for any dividends paid out of pre-acquisition reserves, and impairments.

5. When the cost of investment is restated under IAS 27, on transition to IFRSs, the pre-acquisition reserves would also need to be restated accordingly in order to determine which distributions are a recovery of the initial investment. This would require a reconstruction of pre-acquisition reserves under IFRSs. Constituents argue that the related compliance burden has led to many entities choosing to prepare the separate financial statements of parent entities in local GAAP rather than in accordance with IFRSs. [2]

Structure of paper

6. The paper is structured as follows:

   - Staff recommendation;
   - Background – a discussion of the issues, the effect of these issues and the consultations with IFRIC;
   - Project issues – a discussion about the main issues that the staff believes will need to be considered in this project;
   - IASB agenda criteria – an analysis of the proposed project relative to the agenda criteria set out in the draft IASB due process handbook; and
   - Proposed project plan.

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[1] For example, if Entity A purchased 100% of Entity B by providing 100,000 CU1 shares to the shareholders of Entity B as consideration, the investment would be recorded as CU100,000 in the separate financial statements of Entity A. This is regardless of the fair value of those shares.

[2] Correspondence with the staff suggests that the top 100 listed entities in the UK alone file 40,000 separate financial statements for parent entities within their structures

7. The staff has also provided background information in appendices as follows:

- Paper presented to IFRIC agenda committee in February 2006 (Appendix A); and
- Paper presented to IFRIC in March 2006 (Appendix B).

Staff recommendation

8. The staff recommend that the Board add this project to its technical agenda. If left unresolved, these issues will remain an impediment to the adoption of IFRS for parent entities required to prepare separate financial statements.

9. The project to resolve the issue is not expected to place a considerable strain on Board or staff resources given its narrow scope. The staff expect to be able to prepare a timely and straightforward solution to the issues presented.

Background

10. On first time adoption of IFRSs, 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 as per IAS 27 or fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement.*[3] This also applies to joint ventures and investments in associates.[4]

11. IAS 27 paragraph 4 describes the cost method as follows; 'the cost method is a method of accounting for an investment whereby the investment is recognised at cost. The 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. Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment'. This definition of the cost method was added to IAS 27 as part of the improvements project.

[3] As required by IAS 27 (37).

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

12. In some countries, the accounting practice for establishing cost has sometimes been dissimilar to that of the current IAS 27. However, IFRS 1 does not exempt entities on first time adoption from having to restate the cost of an investment in a subsidiary to meet the requirements of IAS 27. As such, entities that are required to prepare separate financial standards and have an investment in a subsidiary will be required to restate these investments in accordance with IAS 27.

13. 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'.[5]

14. 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 in some respects. The constituents argue that it is inconsistent to exempt an entity from reopening a business combination whilst requiring a reconstruction of the cost of an investment in a subsidiary upon first time adoption.

15. Using the example of merger relief accounting, the difficulties of restating cost can be highlighted. Pre-transition to IFRSs, assume Entity A purchases 100% of Entity B's share capital for CU100,000 (comprised of 10,000 shares with a fair value of CU10 and a nominal value of CU1). Entity A elects to merger account for entity B. The cost recorded in the separate financial statements of Entity A would be CU10,000.

16. 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 CU100,000) and then adjusting for any dividends that had been received from pre-acquisition reserves.

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[5] IFRS 1 BC 32

17. The situation becomes difficult when the 'fair value' of the initial consideration has not been recorded and the consideration was shares in an unlisted company for which no historical market value data exists. If fair value records have not been kept, an entity would be required to revisit the initial acquisition to reconstruct the fair value in order to determine the cost of acquisition.

18. 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, constituents argue that there will be a significant cost to industry in applying IAS because they have not consistently retained information that would enable them to determine whether dividends were paid out of pre- or post-acquisition profits. Further, constituents argue that the information required for restating amounts might not be available. This would involve making the same types of judgements about the assets and liabilities being acquired that IFRS 1 provides relief from for business combinations.

IFRIC

19. The issues have been discussed at the IFRIC Agenda Committee meetings in September 2005, January 2006 and February 2006. The focus of these meetings was two possible sources of relief from restating the cost of the investment under IAS 27 upon initial adoption of IFRS. The result of these meetings was that Agenda Committee concluded that the requirements of IFRS 1 are clear and that they do not provide relief from a requirement to remeasure the carrying amount of the subsidiary in accordance with IAS 27. In March 2006, IFRIC agreed not to take the matter onto its agenda.

Consolidated accounts

20. The measurement of cost under IAS 27 on first time adoption also has implications for business combinations. IFRS 1 B2 (j) discusses the situation where under a previous GAAP an entity may not have consolidated a subsidiary. The cost of the subsidiary in the separate financial statements of the parent is required in these situations in order to determine the deemed cost of goodwill.

Project issues

Scope of the proposed project

21. The scope of this project is restricted to transitional arrangements on first time adoption of IFRS relating to the cost of a subsidiary investment in the separate financial statements of the parent.

Accounting issues to be considered in the project

22. The significant accounting issues to be considered concern the transitional provisions provided for recording the cost of an investment in a subsidiary and the pre-acquisition reserves of that subsidiary on first time adoption of IFRS.

23. The staff have undertaken an initial assessment of possible approaches to the issue to relieve entities from having to restate the cost of the investment in the separate financial statements of the parent, whilst ensuring that high quality information on the investment in the subsidiary is reported. Two possible solutions are as follows:

24. *Option 1* - The parent could be given the option of electing to carry forward the cost of the subsidiary presented in its most recent financial statements prior to the date of transition to IFRS (pre-IFRS transition cost). This carry forward cost would be subject to an impairment test. It would be a simple option on transition. Under this approach no assessments of dividends (as to pre or post acquisition returns) would be imposed. However, the resulting carrying amount would have no meaning under IFRS.

25. *Option 2* - The parent could elect to 'roll up' the cost from the assets and liabilities of the subsidiary upon adoption of IFRS. This would create a deemed cost equal to the net equity of the subsidiary at the date of transition. Whilst this deemed cost figure would not (in most cases) be the equivalent of cost in accordance with IAS 27, it would be representative of the underlying investment in the assets and liabilities of the subsidiary at the date of transition to IFRS. This carrying amount would provide a more meaningful carrying amount than a carry forward of the pre-IFRS transition cost (which in some countries could be artificially low due to a situations such as differing

standards on acquisition accounting). The pre-acquisition reserves could be restated to equate to reserves on initial adoption of IFRS.

26. These potential solutions would need to be considered during the course of the project (in addition to any other possible solutions devised). At present, these solutions are for illustrative purposes only and are not intended for debate / discussion at this meeting.

IASB agenda criteria

27. The draft IASB due process handbook sets out five criteria to be considered in deciding whether to add a potential item to the agenda:

- The relevance to users of the information involved and the reliability of information that could be provided;
- Existing guidance available;
- Possibility of increasing convergence;
- Quality of the standards to be developed; and
- Resource constraints.

The relevance to users of the information involved and the reliability of information that could be provided

28. The objective of a project should be to address a demand for better quality information that is of value to all users of financial statements. In considering this, there are four main factors to consider:

International relevance

29. These issues have relevance to several jurisdictions. Issue 1 has particular relevance to countries where merger relief accounting or other such methods of acquisition accounting other than cost under IAS 27 have been practised. Issue 2 has potential to affect all parent entities that are required to produce separate financial statements and

have previously practised a method of accounting for investments in subsidiaries that is not consistent with the cost method under IAS 27.

Pervasiveness

30. Constituents suggest the issues affect several different types of entities in different jurisdictions. These issues are will persist if left unresolved.

Urgency

31. Currently, entities in countries such as the UK and Hong Kong can elect whether to prepare their separate financial statements under IFRS or local GAAP. As such, there is no immediate urgency to the resolution of this issue. However, the goal of the IASB is to ensure a consistent accounting framework worldwide, and these issues if left unresolved, will hamper progress as entities may elect not to transition to IFRS due to the costs outweighing the benefits.

Consequences of not taking on this project

32. In the absence of amendments or changes with regard to these issues, potential first time adopters who are required to present separate financial statements will be deterred from adopting IFRS. In the UK for example, many entities are electing not to adopt IFRS in their separate financial statements and are running parallel records. This is because of the cost of complying with IFRS in their current form.

Existing guidance available

33. There is an existing requirement under IFRS 1 that, on first-time adoption of IFRSs, the cost of a subsidiary be restated to comply with IAS 27. There is no relief from this requirement provided by IFRS 1.

34. The issues create a significant compliance cost for entities in jurisdictions that have used accounting treatments dissimilar to those provided in IAS 27 for the cost of investment in subsidiaries.

Possibility of increasing convergence

35. IFRS 1 in its current form may act as an impediment for some entities considering first time adoption or regulators considering requiring IFRS for separate financial statements. In Europe, the European Commission has regulated that all listed companies must use IFRS for preparing their consolidated financial statements from 2005 onwards. However, the adoption of IFRS for unlisted entities and the separate financial statements of listed entities is not mandatory. It is expected that a number of companies will be unwilling to adopt IFRS voluntarily due to the costs outweighing the perceived benefits.

36. Given this is a first time adoption issue, there is no specific benefit to convergence with US GAAP from any amendment to IFRS in its current form.

Quality of the standards to be developed

Availability of alternative solutions

37. The staff view is that it will be possible to develop an alternative solution that will improve relevance, reliability, understandability and comparability in financial reporting of separate financial statements of a parent.

Cost/benefit considerations

38. There should be no external costs to the IASB regarding this project. The only cost of note is staff and Board meeting time.

39. The benefits of the timely completion of this project far outweigh these costs as it will assist in creating a solution to first time adoption that can encourage the conversion of entities in various jurisdictions.

Feasibility

40. The staff believe that there is a suitable and workable solution to this issue. There are several possibilities that have been considered to date. The staff, however, require appropriate time to consider these possibilities in more depth.

Resource constraints

Availability of expertise outside the IASB

41. There is no requirement for expertise from parties outside of the IASB.

Amount of additional research required

42. There will be minimal research required to be conducted outside the IASB. There may be liaison with national standard-setters. However, this is likely to be informal and infrequent. Any solution to this issue will require consideration of differing frameworks in several countries to ensure that it is robust.

Conclusion

43. The staff view is that the proposed project satisfies the Board's criteria for adding a project to its technical agenda.

Proposed project plan

44. If the Board accepts the staff recommendations with regard to this project, we expect to commence work in April 2006. The staff requirements for this project are expected to be 8 days for a Project Manager, 2 days for a Senior Project Manager, 2 hours for a Technical Director and Board time intermittently outside of Board meetings.

45. The significant focus of this project will be how to amend the current standards to ensure first time adopters are not unnecessarily burdened whilst still being consistent with the Board's primary objective of making a first time adopters financial statements comparable over time.

46. We propose to submit a paper to the May Board meeting outlining possible solutions to the problem.

47. Following the May Board meeting, the staff expect to be able to prepare the amendments for exposure by July. The staff anticipate exposing the amendment for a shorter period that that standard 120 days.

Appendix A – Paper presented to IFRIC Agenda Committee

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

Cost of a subsidiary in the separate financial statements of a parent

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ISSUE

1. The IFRIC has been asked to consider 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.

2. Constituents believe that IFRS 1 is not sufficiently clear on whether investments should be restated upon transition to IFRS or if the exemptions applicable to business combinations on transition to IFRS should apply. They believe that there would be significant difficulty and cost involved in recreating the cost of investments in subsidiaries undertaken by a parent before its adoption of IFRSs.

3. Under IAS 27, there is a requirement to assess dividends as pre- or post- acquisition. IAS 27 requires cost to be initially stated at the amount of consideration paid. This cost will be adjusted over time by any dividends paid out of pre-acquisition reserves and impairments. If the IFRS cost of investment is restated under IAS 27, the pre-acquisition reserves would also need to be restated accordingly. This would require a reconstruction of pre-acquisition reserves under IFRSs.

4. This matter has been highlighted by the use of merger relief accounting in the United Kingdom. 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.[6] This method of accounting for the carrying amount of an

[6] 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.

investment in a subsidiary does not comply with IAS 27 *Consolidated and Separate Financial Statements*. The issue is only applicable to the separate financial statements of the parent.

Purpose

5. This matter has 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 have been asked to perform further analysis as to the most appropriate resolution of this issue.

6. The purpose of this paper is to conclude as to whether IFRIC should issue an Interpretation on the matter or recommend to the Board that IFRS 1 be changed.

IFRS 1

7. 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'.[7] 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.

8. 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.

9. 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

[7] IFRS 1 BC 32

dividends are required to be deducted from cost. If IFRS 1 is applied in its current form, constituents argue that there will be a significant cost to industry in applying IAS 27 as items such cost and pre-acquisition reserves will need to be restated. Further, constituents argue that the information required for restating amounts might not be available.

10. This can be illustrated using the example of merger relief accounting. Pre-transition to IFRSs, 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 merger account for entity B. The cost recorded in the separate financial statements of Entity A would be £10,000.

11. 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.

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

Analysis

12. IFRS 1 does not specify explicit 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.

13. 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).[8] Whilst there is no explicit statement in IFRS 1 regarding exemptions relating to investments in subsidiaries in the separate financial

[8] IFRS 1 Appendix B – B1.

statements of the parent, it has been argued by staff that the exemptions provided for business combinations could be extended to IAS 27. Constituents do not believe such an argument can be made.

14. 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.

15. 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 constituents. The carrying amount of a subsidiary could be carried forward at its pre-IFRS amount and subject to impairment tests upon first time adoption.

16. 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.

17. 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.*[9] This would also apply to joint ventures and investments in associates.[10]

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[9] As required by IAS 27 (37).

[10] 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

18. One exemption previously 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.

19. 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:

20. 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.

21. 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 is initially comprised of 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 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.

22. However, the principle in this exemption allows consideration of the implications of 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. This would provide a number which would be relatively easy to calculate on first time adoption.

Potential amendments

23. The staff believe that the treatment of cost in the separate financial statements of the parent has not been addressed satisfactorily in IFRS 1. Given the intention of the exemption available to restating business combinations, it should have been extended to cost in the separate statements of the parent. Compelling entities to re-visit every pre-transition cost of investment calculation is inconsistent with the principles in IFRS 1.

24. The staff have considered how best to amend IFRS 1 to relieve entities from having to restate the cost of the investment in the separate financial statements of the parent. The staff suggest two possibilities:

25. *Option 1* - The parent could elect to carry forward the pre-IFRS transition cost of the subsidiary. This carry forward cost would be subject to an impairment test. It would also be the simplest option on transition. Assessments of dividends (as to pre or post acquisition returns) would be unchanged from the previous GAAP. However, this option would carry forward an amount that might not be representative of cost per IAS 27 or the underlying assets and liabilities.

26. *Option 2* - The parent could elect to 'roll up' the cost from the assets and liabilities of the subsidiary upon adoption of IFRS. This would create a deemed cost equal to the net equity of the subsidiary at the date of transition. Whilst this deemed cost figure would not (in most cases) be the equivalent of cost per IAS 27, it would be representative of the underlying investment in the assets and liabilities of the subsidiary. This carrying amount would provide a more meaningful carrying amount than a carry forward of the pre-IFRS cost (which in some countries could be artificially low due to a situations such as differing standards on acquisition accounting). The pre-acquisition reserves could be restated to equate to reserves on initial adoption of IFRS.

Recommendation

27. The staff recommendation is that IFRS 1 be amended. Interpretation alone is not sufficient in this instance to resolve the issues put forward by constituents. The staff recommend that IFRIC should not take this matter onto its agenda and that a recommendation be made to the Board to change IFRS 1.

Appendix B – Paper presented to IFRIC

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

Cost of a subsidiary in the separate financial statements of a parent

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.

2. *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?

3. The constituents 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.

4. 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.[11]

5. *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?

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[11] 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.

6. 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.

7. 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.

8. 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

9. 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.

10. 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 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

11. 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.

12. 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 to Appendix B - 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'.[12] 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, constituents 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, constituents 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

[12] IFRS 1 BC 32

(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.

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).[13]

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 constituents. 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

[13] IFRS 1 Appendix B – B1.

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.*[14] This would also apply to joint ventures and investments in associates.[15]

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

[14] As required by IAS 27 (37).

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

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.