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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **25 May 2006, London**

Project: **Cost of a subsidiary in the separate financial statements of a parent on first time adoption of IFRSs (Agenda Paper 9)**

Introduction

1. At its March 2006 meeting, the Board decided to add a project to its technical agenda to resolve issues in relation to measuring the cost of a subsidiary in the separate financial statements of a parent on first time adoption of IFRSs.

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

3. The purpose of this paper is to recommend a solution to the issues discussed at the March 2006 Board meeting.

Staff Recommendation

4. The staff recommends that IFRS 1 *First Time Adoption of International Financial Reporting Standards* be amended to allow a parent to use the pre-transition carrying amount of an investment in a subsidiary as deemed cost on transition to IFRSs.

5. Relief should also be provided from re-stating pre-acquisition reserves in accordance with IFRSs. The staff recommends that the pre-acquisition accumulated profits under national GAAP are carried over on transition to IFRSs.

6. Further, the staff recommends that any relief should be available only to a parent entity to which IAS 27.10 applies, and when it would be impractical for that entity to restate cost in accordance with IAS 27.

Background

7. The cost of an investment in a subsidiary must be calculated in accordance with IAS 27. 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.

8. The IFRIC was asked to consider whether the exemption from having to restate a business combination provided by IFRS 1 allows entities to also avoid having to restate the cost of the investment in a subsidiary. The correspondent had highlighted the difficulties in measuring the cost of an investment in a subsidiary that can 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 the 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.

9. 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.

10. The IFRIC concluded that the IFRS 1 exemption that relieves entities from having to recreate business combinations does not provide equivalent relief from the requirement to reconstruct the same data for the purposes of IAS 27.

11. In addition to measuring the initial purchase of a subsidiary at cost, there is sometimes difficulty 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 revenue.

12. 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, companies will need to reassess each dividend paid by a subsidiary post-acquisition to determine whether they were a return of capital (and hence deducted from the cost of the investment in the subsidiary).

13. The Board has agreed that this issue warrants an amendment to IFRS 1. The staff have developed possible solutions, the analysis of which is provided below.

Staff Analysis

Deemed cost on transition to IFRSs

14. The staff have considered three options as an alternative to cost in accordance with IAS 27. Each of these options is discussed below and focuses on using a deemed cost.

15. Currently, the IAS 27 carrying amount of an investment in a subsidiary in the separate financial statements of a parent can be recorded at its historical cost (being the amount of consideration paid) or fair value.

16. In developing the options below, the staff have considered two key aspects in selecting the best option available:

- the expected benefits and usefulness of the information that would be produced; and
- the simplicity of each option and its respective cost of compliance.

The staff have also considered the relevant scope of the exemption.

17. *Option 1 - Use the previous GAAP cost as deemed cost* – Retaining the previous GAAP cost of an investment in a subsidiary on transition to IFRS is the simplest option. It is also consistent with the exemption provided to restating business combinations in IFRS 1 at present. That is to say, it relieves the entity from having to recreate the data at the date of acquisition.

18. This option is likely to result in a measured cost that has low information content, particularly where nominal values were used to measure cost. It is arguable that other methods are more likely to provide more useful information to users of financial statements. This deemed cost will be assessed for impairment at the date of transition to ensure that the value attributed to cost does not exceed its recoverable amount (see paragraphs 32-33).

19. *Option 2 – Use the IFRSs carrying value of the net assets of the subsidiary at transition date as deemed cost* – Using this option, the IFRSs carrying value of the net assets of the subsidiary would be regarded as the deemed cost of the subsidiary in the separate financial statements of the parent on first time adoption by the parent. This approach would align the carrying amount of an investment in a subsidiary with its IFRS compliant position at the date of transition.

20. The benefit of this approach is, as with option 1, it is relatively simple to obtain the required information (as it is required to prepare the consolidation). The deemed cost would provide information to users about the underlying net financial position of the subsidiary measured using IFRSs at the date of the parent's transition to IFRSs.

21. Whilst the information content is increased, the staff note that any loss incurred by the subsidiary in the periods immediately following transition could result in that cost being impaired. Further, by aligning the carrying

amount of an investment in a subsidiary with its underlying net asset position, in some circumstances, the subsidiary will be required to justify a higher recoverable amount relative to its previous carrying amount.

22. This creates a bias in the treatment of the cost of investment in a subsidiary on transition to IFRSs as losses would not be offset against profits accumulated prior to transition. The staff believe that this outcome may dissuade some constituents from adopting IFRSs as the risk of impairment may negatively affect the performance of the parent entities.

23. *Option 3 – Fair value as deemed cost* – Recording the cost of a subsidiary at fair value is already one of the permitted measurement bases in IAS 27. The fair value of the investment in the subsidiary at the date of transition of the parent to IFRSs could be used as a deemed cost. Subsequent to the transition to IFRSs, a parent would continue to use the cost method, in accordance with IAS 27, to account for the investment in the subsidiary.

24. Parent entities have a choice on first time adoption of IFRSs as to whether to use the cost method or fair value to account for investments in subsidiaries. In those circumstances when cost is difficult to measure the entity has the option of measuring its investments in subsidiaries at fair value. The difference between the exception considered here (fair value as deemed cost) and fair value measurement under IAS 27 is that this exception would not require the parent entity to re-measure the carrying amount of the subsidiary at fair value at each reporting date. It is the ongoing requirement that appears to dissuade some parent entities from adopting that option and, hence, adopting IFRSs.

25. Using fair value to determine a deemed cost on transition would provide the parent and investors with a current fair value of the subsidiary. However, there may be significant cost and effort involved in obtaining these fair values, particularly in structures where the subsidiary itself has one or more subsidiaries and other assets and liabilities that are not in active markets.

26. As with the option 2 there would also be an increased likelihood of a parent reporting an impairment were any losses incurred in the periods immediately following transition (see paragraph 21-22).

Staff recommendation

27. The staff believe that the most appropriate option would be to allow the use of the previous GAAP carrying amount of an investment in a subsidiary as deemed cost.

28. The net benefit obtained from aligning the cost of an investment in a subsidiary on first time adoption with its underlying position (option 2) or fair value (option 3) is minor. The use of those amounts would provide better information about the underlying subsidiary in the short-term but the informational advantage will diminish over time.

29. Further, with option 2 and option 3, there is an increased cost of compliance (option 3 only) and risk of impairment. These factors may dissuade some constituents from adopting IFRSs.

30. Does the Board agree that the previous GAAP carrying amount for the cost of an investment in a subsidiary in the separate financial statements of a parent should be the basis for measuring the deemed cost on first time adoption of IFRSs by a parent entity?

31. The exemption to IFRS 1 should state that the cost of an investment in a subsidiary in the separate financial statements of a parent will be deemed to be the equivalent of cost in accordance with IAS 27.

Impairment

32. If the Board agrees to use the previous GAAP carrying amount as deemed cost, an impairment test will ensure that the carrying amount of the investment in the subsidiary did not exceed its recoverable amount at the date of transition.

33. This impairment test will be conducted when preparing the opening balance sheet numbers required for transition to IFRSs. IAS 36 requires an assessment of impairment to be conducted at the end of a reporting period. This end of period assessment will be required in order to produce the opening balances of the entity's first IFRS balance sheet. Accordingly,

because there is already a requirement to assess the carrying amount for impairment, it is not necessary to add a requirement in IFRS 1.

Post transition dividends

34. If IFRS 1 was amended in accordance with any of the three options above, there would, arguably, still be an issue regarding dividends paid after the transition to IFRSs.

35. 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. Distributions in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment'.

36. In order to determine which dividends are from pre- or post-acquisition profits, the staff believe that pre-acquisition reserves would need to be restated to an IFRSs compliant amount. Restating pre-acquisition reserves to be compliant with IFRSs would be a task tantamount to restating business combinations (for which there is an exemption in IFRS 1). However, these reserves are necessary in order to calculate what dividends are pre- or post-acquisition subsequent to transition to IFRSs.

37. To illustrate, assume Company A purchases 100% of the share capital of Company B. Company A and Company B do not use IFRS at the time of this transaction. All profits recorded by Company B after the transaction are distributed to Company A.

38. Two reporting periods after the transaction, Company A and Company B decide to adopt IFRSs. On transition, Company B's balance sheet is adjusted for differences between its previous GAAP and IFRSs. As a result of these differences, the transition-date balance sheet has lower equity than was reported under the previous GAAP. The reason for this is that the accumulated profits under IFRSs would have been lower than were reported under the old GAAP.

39. Given that Company B has a policy of distributing all profits as dividends, on transition to IFRS, it would have distributed a portion of profits that under IFRSs would have been classified as pre-acquisition. The portion of pre-acquisition profits that were paid to Company A should be adjusted, in line with IAS 27, against the investment in Company B in Company A's financial statements.

40. Does the Board agree that in order to assess a dividend as pre- or post-acquisition that, unless relief is provided, the pre-acquisition reserves of an entity will need to be restated in accordance with IFRSs to determine which dividends are pre- and post- acquisition?

41. Providing the Board agrees with this view, given the difficulties of restating pre-acquisition reserves for all subsidiaries, the staff believe that, on transition to IFRSs, an alternative to restating pre-acquisition reserves is required.

42. The staff have considered several options that would relieve an entity from having to restate pre-acquisition reserves in accordance with IFRSs. It should be noted that the options discussed below would only be applicable to entities that had adopted the exemption from restating cost in accordance with IAS 27.

43. *Option 1* – Consistent with option 1 in 'deemed cost on transition to IFRSs' above, the same pre-acquisition accumulated profits used under the previous GAAP could be used on transition to IFRSs. This would be straightforward and simple to apply. However, this has ongoing implications, as it may allow an investor (post adoption of IFRSs) to recognise as dividend income, distributions that would not qualify as such in accordance with IAS 27 paragraph 4.

44. *Option 2* – Another solution to the issue could be to designate all pre-transition retained earnings as pre-acquisition. This would require only dividends paid out of post-transition profits to be considered income to the parent. This method would ensure that entities could not pay dividends and consider them income when arrangements such as merger relief had been used. However, this option could unfairly penalise these parent entities by reducing the dividends received from the subsidiary that can be treated as dividend income merely because they had used an exemption from restating cost in accordance with IAS 27. Where such distributions are not treated as dividend income, the parent entity does not generate profits available for distribution to its shareholders.

45. The staff recommend that option 1 is the better option as it is consistent with the staff recommendation on the deemed cost. Using option 2 may create a situation where a parent entity is unable to recognise dividend income from profits that have been made subsequent to its acquisition of a subsidiary.

46. Does the Board agree with this recommendation?

Definition of cost in IAS 27

47. The staff also considered whether the definition of the cost method in IAS 27 should be changed. By referring to dividends from post-acquisition accumulated profits the staff believe that IAS 27 is overly restrictive in that it ignores revenues and expenses that are recognised directly in equity. One possibility is to amend the definition so that it refers to dividends from total post-acquisition recognised income and expense. This wording would also be consistent with that proposed in the revised IAS 1, issued in March this year.

48. However, changing the cost method requires further analysis. Therefore, the staff recommend that no change to the cost method is made at this stage. The staff proposes to review the application of the cost method in the current project on control. At this stage, the staff will be able to assess if there are any unintended consequences of changing the cost method.

49. Does the Board want the staff to examine this matter further at this time or as part of the control project?

Scope

50. The staff considered three scope restrictions which are discussed below:

Restriction to share for share exchanges

51. The staff considered whether a scope limitation was appropriate. The relief provided to a parent entity from restating the cost of investments in subsidiaries on first time adoption of IFRSs could be restricted to circumstances where a share for share exchange has occurred to acquire the entity and the fair value of this exchange cannot be reasonably determined. Limiting the relief to share for share exchange transactions ignores the impact of post-acquisition dividends on cost. Further, there may be transactions other than share for share exchanges for which it is difficult to restate cost that have not yet been identified in practice. Accordingly, the staff do not recommend a scope limitation.

Impracticability

52. The staff also considered whether the option should be unconditionally available to all entities within the scope of the proposal or whether it should be limited to those circumstances where it is impractical to measure cost in accordance with IAS 27.

53. The staff consider that "impractical to measure cost in accordance with IAS 27" should be defined as the imposition of an unreasonable burden in recreating of cost of an investment in a subsidiary in accordance with IAS 27 on the parent entities in question. The staff believe that providing an impracticality clause will reflect the purpose of the proposal as the reason for the initial request for relief has been made on these grounds.

Entities not presenting consolidated financial statements

54. The staff also considered whether it would be appropriate to provide this exemption only to entities that elect not to present consolidated financial statements, in accordance with IAS 27.10[1]. The staff believe that the entities that originally raised the concerns regarding the cost of an investment in a subsidiary on first time adoption are predominately entities to which IAS 27.10 applies.

55. The staff recommend that the proposed relief should be available to parent entities to which IAS 27.10 applies, and for which it would be impractical to restate cost in accordance with IAS 27. By providing the relief on the grounds of impracticability, parent entities will need to demonstrate why they are unable to restate cost in accordance with IFRSs. Further, by providing the exemption to parent entities to which IAS 27.10 does not apply, public entities (which have users with higher information needs) will still be required to restate cost in accordance with IAS 27.

56. **Does the Board agree with this recommendation?**

Disclosure

57. The staff considered whether it should be necessary for an entity to disclose that the relief from restating cost in accordance with IAS 27 has been adopted in its financial statements. The staff note the Board did not require an entity that had not restated its business combinations to disclose this fact in its first IFRS financial statements. The staff believe that, similarly, an entity measuring cost using the proposed deemed cost provisions should not be required to disclose this fact as it would provide minimal informational benefit.

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[1] IAS 27.10 - A parent need not present consolidated financial statements if and only if:

(a) the parent is itself a wholly-owned subsidiary, or is a partially-owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(b) the parent's debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(c) the parent did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(d) the ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with International Financial Reporting Standards.

58. Does the Board agree that parent entities who have applied the relief relating to the cost of an investment in a subsidiary should not have to disclose that fact?