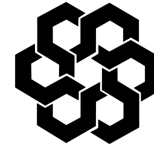

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **19 July 2007, London**

Project: **IAS 27—Accounting in the separate financial statements for the formation of a new parent (Agenda Paper 6)**

INTRODUCTION

1. IAS 27 *Consolidated and Separate Financial Statements* requires investments in subsidiaries to be accounted for in the separate financial statements either at cost or in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. The Board has been made aware that this requirement might be a potential accounting impediment to entities adopting a more prudentially sound corporate structure. This is because IFRSs is being interpreted as requiring a newly formed parent entity to measure its investment in the previous parent at fair value. This paper outlines the case for the Board to consider making a limited amendment to IAS 27 to remove this impediment and asks the Board how it wants to proceed.[1]

[1] The staff notes that the alternatives considered in this paper would not affect the Board's project on the cost of an investment in a subsidiary in the separate financial statements of a parent on first time adoption of IFRSs. This is because the proposed alternatives involve making a scope exception to IAS 27.37, rather than interpreting the meaning of cost in the context of the formation of a new parent.

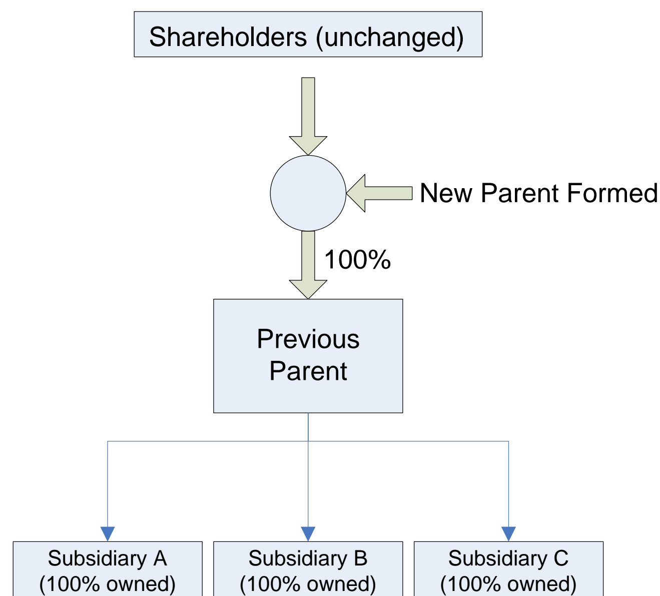
BACKGROUND

2. In some jurisdictions, prudential standards set limits on the risk exposures of banks to other parts of their corporate groups. This encourages financial institutions to establish more prudentially sound corporate structures.

3. One way to comply with the prudential requirements is to establish a new non-operating holding company (NOHC) for an existing group. Rather than being established *within* the group, the NewCo becomes the parent of the existing parent. This type of reorganisation normally involves NewCo issuing new shares to the shareholders of the previous parent in a one-for-one exchange for their shares in the previous parent. This puts the shareholders in the same position in relation to the group as before the restructuring. There is no change in the actual or relative ownership interests and no change in the assets or liabilities of the group.

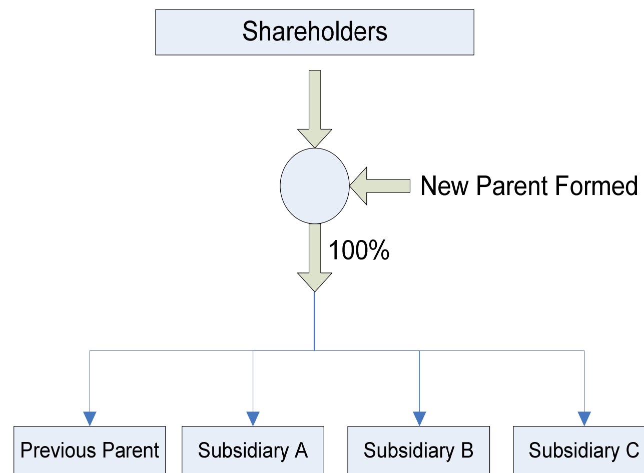
4. The following diagram shows a typical structure:

B.



5. A NOHC structure is used to separate the risks in various parts of a financial conglomerate (eg to separate banking activities from non-banking activities and/or to separate offshore operations from domestic operations). A NOHC structure allows depositors to receive the benefits of prudential oversight without placing limitations on financial institutions' expansions of non-banking activities.

6. For example, if the banking activities were conducted by Previous Parent and other activities (such as insurance, funds management, etc.) were conducted by Subsidiary A, Subsidiary B and Subsidiary C, the NOHC structure might be as follows:



REQUIREMENTS AND CONSEQUENCES OF IAS 27

7. IAS 27.37 requires investments in subsidiaries (except those classified as held for sale) to be accounted for in the separate financial statements either at cost or in accordance with IAS 39.

8. IAS 27 does not define cost. However, by analogy to other IFRSs (eg IAS 16, IAS 38, IAS 39 and IFRS 3), most interpret cost to be the fair value of the consideration given. In this case, the cost of the investment would be the fair value of the shares issued by NewCo. The fair value of the shares issued by NewCo is measured by reference to what was received. Accordingly, the consideration given and the investment in the previous parent are measured at the fair value of the existing group.

9. There has been no change in the economic resources of the group—the new parent does not bring any assets or liabilities to the group and the position of the shareholders in relation to the group has not changed. The group balance sheet will be the same as before the reorganisation. What will change is that the group has a new legal parent which will report its interest in the group as if it had acquired the group at the date of the reorganisation.

10. Because the position of the shareholders has not changed as a result of the reorganisation, some believe that it is misleading to permit or require a parent entity to remeasure the net assets and equity of a group by changing the legal structure of the group. In addition, measuring the investment in the previous parent at fair value has the following consequences:

    a. It might be costly to value the entire group with no significant benefit to users of the financial statements.

    b. NewCo might subsequently have to recognise an impairment of its investment that would not have been recognised by the old parent. This is because the old parent might have carried its investments at low historical costs, whereas NewCo's investment will be at fair value. Therefore, even though the economic risk of the group has not changed, the reorganisation creates an accounting impairment risk that didn't exist previously.

    c. All of the net assets below NewCo are pre-acquisition and therefore cannot be used to pay dividends to the NewCo that will be regarded as income.

    d. The requirement to measure the group at fair value can also have tax consequences.

11. Some jurisdictions already have taken steps to address potential legal and tax impediments that might have prevented entities from adopting a NOHC structure. However, the potential accounting impediment remains. To remove that impediment it would be necessary to amend IAS 27 to relieve a new parent from measuring its investment in the old parent at fair value in its separate financial statements.

THE WAY FORWARD

12. There are two ways that the Board could proceed on this matter. It could decide to do nothing or it could provide some relief.

13. The approach to providing relief would be to exempt the new parent from paragraph 37 of IAS 27. The exemption would be limited to those cases for which a parent is formed within a group or over an existing single entity when and only when there are no changes in the equity, assets, or liabilities of the group or in the relative interests of equity holders.

    a. It might be possible to develop a narrow amendment without affecting the accounting for other group reorganisations. [Remainder of paragraph not reproduced in observer notes.]

14. If the Board decides to provide relief, it could either specify the accounting or leave the requirements open (with a view to considering the accounting as part of a broader consideration of common control transactions).

15. If the Board decides to specify the accounting, the following application guidance (or something similar) could be added to IAS 27:

> The formation of a new parent does not constitute a purchase or other event that justifies the re-measurement of the equity, assets and liabilities of the entities within the group. Nor does it justify establishing a cost or fair value under IAS 27.37 in the new parent other than by reference to existing carrying amounts. No exchange or event of economic consequence has occurred and essentially all that has taken place is that owners hold equivalent scrip in the same group. The formation of a new parent is no more than a reallocation of existing group equities, assets and liabilities among group entities (including the new parent) that takes place by reference to existing carrying amounts.
>
> And further, irrespective of any relocation of retained earnings or reserves within the group, their status as pre or post acquisition (for the purposes of consolidation or the recording of dividends in separate financial statements) is unchanged by the formation of the new parent. This is because there has been no acquisition by the new parent or any other form of exchange or event that would change that status.

16. Paragraph B24 of FASB Statement No. 141, *Business Combinations,* states that its requirements do not address recapitalisations and other new entity formations. The staff has been told that US practice is to use carryover basis.

STAFF ANALYSIS

17. The staff believes that it is possible to develop a scope exception to IAS 27.37 that is limited to the formation of a new parent and does not include all reverse

acquisitions and common control transactions. However, we will need to be very careful in defining ‘the formation of a new parent’ and in describing the basis for the exception so that it is not analogised to other situations. The scope exception must be limited to situations in which there are no changes in the equity, assets or liabilities of the group or in the relative interests of the owners of the group.

18. However, the staff is concerned that specifying the accounting for the formation of a new parent (as proposed in paragraph 15 above) might have unintended implications for other group reorganisations. The staff is concerned that constituents might apply the proposed application guidance by analogy to other situations not explicitly addressed in the standard such as the accounting for reverse acquisition or common control transactions in separate financial statements. In particular, this is a concern in the situation illustrated in paragraph 6.

19. As a consequence, the staff is concerned that the proposed amendment might prejudge the deliberations in a potential project on common control. Therefore, an alternative would be to exclude the formation of a new parent from the scope of IAS 27.37, but not provide any guidance on the appropriate accounting (ie leave open the measurement of the investment). Entities would apply the guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in determining the appropriate accounting.

20. The staff acknowledges that it is not ideal not to specify the accounting for the formation of a new parent. However, this might be the best option if the Board wants to remove the accounting impediment to the formation of new parent entities, but does not want to specify the required accounting until it considers related issues (accounting in the separate financial statements for common control transactions and reverse acquisitions) more broadly.

21. The staff has found it difficult to make a recommendation on this matter. There are many ways that an entity could reorganise its activities that do not have any accounting consequences. It is arguable that the method of reorganisation should not generate different accounting solutions if the legal and economic resources of the group are unchanged. The reorganisation of entities is often made to provide more effective risk management of the group. It seems inconsistent to introduce

accounting impairment risk when the economic risk to the parent might well have been reduced.

22. On the other hand, the new parent is a new legal entity and the general principle in IFRSs is that the initial recognition of the shares in its subsidiaries should be at fair value.

23. The staff thinks that it is possible to develop a narrow exception and make it clear that the exception cannot be analogised to other types of transactions, such as common control transactions.

QUESTIONS FOR THE BOARD

24. Does the Board want to make a limited amendment to IAS 27 to exclude the formation of a new parent from the scope of IAS 27.37?

25. If so, does the Board want to specify the accounting for the formation of a new parent or remain silent?

If the Board decides to make a limited amendment the staff will prepare a draft amendment for balloting.