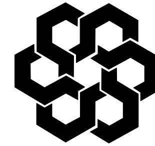

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International Accounting Standards Board

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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:	**21 June 2007, London**
Project:	**Cost of an investment in a subsidiary in the separate financial statements of a parent on first time adoption of IFRSs**
Subject:	**Comment Letter Analysis (Agenda paper 10A)**

INTRODUCTION

1. The comment period on the exposure draft [ED] of Amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards Cost of an Investment in a Subsidiary* ended on 27 April 2007. The Board received comment letters on the ED from 47 respondents including preparers, accounting firms, accounting bodies, standard setters, and regulators. This paper summarises the comments received on the proposed amendments to IFRS 1.

2. This analysis begins by summarising significant general comments received on the ED. Specific comments on each of the discussion questions asked in the ED are then summarised. The third section of the paper presents editorial suggestions raised by respondents that are independent of the discussion questions asked in the ED. The final section of the paper includes a table that summarises the respondents to the ED by type and geographical area.

GENERAL COMMENTS ON THE ED

Fairness of providing relief to some jurisdictions

3. One respondent indicates that its country's listed companies adopted IFRSs without the relief proposed in the ED, even though they faced the same challenges articulated by the constituency that originally brought this issue before IFRIC. This respondent questioned the need to provide relief from certain requirements of IAS 27 in the first instance.

Project scope

4. The Basis for Conclusions to the ED explains that the proposed amendments to IFRS 1 arise from comments received by the Board about the difficulties, on first-time adoption of IFRSs, of measuring, in the separate financial statements of a parent, the cost of an investment in a subsidiary in accordance with IAS 27 *Consolidated and Separate Financial Statements*. These difficulties result from practices under previous GAAP that are inconsistent with those required by IAS 27. In these circumstances, some believe it is too difficult or even impossible to restate cost in accordance with IFRSs because the information required may be unavailable or difficult to obtain.

5. Many respondents comment that the challenges facing first time adopters in determining cost in accordance with IAS 27 are the same as those facing first time adopters in determining cost in accordance with IAS 28 and IAS 31. These respondents believe that the arguments supporting the proposed amendments to IFRS 1 apply equally well to investments in associates and joint ventures. As a result, the Board is asked to consider broadening the scope of this project so that the same relief proposed for investments in subsidiaries is granted to investments in associates and joint ventures.

Relationship with the exemption granted to business combinations in IFRS 1

6. Some respondents believe that the decision to enable transitional measurement of investments at net asset value or fair value is at odds with the exemption granted from the restatement of business combinations in IFRS 1. These

respondents assert that the investment in a subsidiary, as it is reflected in the separate financial statements of the parent, is simply the other side of the business combination transaction. Consequently, it should receive the same exemption granted to business combinations in IFRS 1. Acceptance of this approach would allow the investment in the subsidiary to be measured at previous national GAAP in the separate financial statements of the parent.

Relationship with IAS 27

7. Many respondents used this opportunity to write at length about their dissatisfaction with IAS 27. Their comments focus on the accounting treatment of dividends currently prescribed by IAS 27. The need to explicitly define the term "cost" was also articulated.

Accounting treatment of dividends received from subsidiaries

8. Even though the Board made concessions in the ED to the basis of valuing subsidiaries and the identification of distributions from pre-acquisition profits, many respondents indicate that the remaining restrictions in IAS 27 as to how pre-acquisition profits are determined will discourage companies from making the transition to IFRS, thereby stripping the relief proposed in the ED of any real value. These respondents suggest that IAS 27 be amended to permit dividends from subsidiaries to be treated as investment income, subject to an impairment test of the value of the subsidiary in the parent's accounts and consideration of whether the dividend is, in substance, a return of capital invested.

Definition of the term "cost" in IAS 27

9. Some respondents request that the Board define the term "cost". These respondents indicate that analogies are generally drawn with other standards for the purpose of defining the cost of an investment under IAS 27. As a result, different interpretations exist as to how cost should be determined in the separate financial statements of a parent, particularly where there have been group reorganisations.

10. Respondents also indicate that a clear definition of cost in IAS 27 would make it easier to determine whether there is a difference between the carrying amount of an investment in a subsidiary under previous GAAP versus that which is calculated under IAS 27. This, in turn, would assist an entity in determining whether or not it should use deemed cost as proposed in the ED.

SPECIFIC COMMENTS—DISCUSSION QUESTIONS

Question 1

IAS 27 requires a parent, in its separate financial statements, to account for an investment in a subsidiary either at cost or at fair value (in accordance with IAS 39 Financial Instruments: Recognition and Measurement). However, the Board believes that in some cases, on first-time adoption of IFRSs, the difficulties in determining cost in accordance with IAS 27 exceed the benefit to users.

This exposure draft proposes to allow a parent, at its date of transition to IFRSs, to use a deemed cost for an investment in a subsidiary. The deemed cost would be determined using either the carrying amount of the net assets of the subsidiary, or its fair value, at that date. Is this appropriate? If not, why?

11. The majority of respondents to Question 1 support the Board's intention to provide relief from the requirement to determine the cost of an investment in a subsidiary in accordance with IAS 27 at first-time adoption of IFRSs. Respondents' comments are largely focused on what form the relief should take.

Fair value of the subsidiary as deemed cost

12. The option to use the fair value of the subsidiary as deemed cost for the investment in that subsidiary upon first-time adoption of IFRSs was met with wide support from respondents. Only two respondents indicate that fair value should not be an option for constituents.

13. A lack of cost/benefit is the primary argument used by those that do not support fair value as an option for deemed cost. Respondents argue that most subsidiaries will not have readily determinable market values and will therefore require separate valuations to be undertaken. As a result, determining the fair value of a parent's investment in a subsidiary upon first-time adoption of IFRSs may be costly and time consuming.

Carrying amount of the net assets of the subsidiary determined in accordance with IFRSs as deemed cost

14. Some respondents believe that using the carrying amount of the net assets of the subsidiary determined in accordance with IFRSs as deemed cost provides users of financial statements with information that accurately reflects the financial position of the subsidiary at the date of transition. These respondents believe that, in most cases, the information required to determine the net assets of the subsidiary in accordance with IFRSs is readily available as it is required for the preparation of the consolidated financial statements. Respondents also indicate that the current nature of this information makes it more relevant to users of financial statements than historical cost.

15. The two primary arguments presented in opposition to using the carrying amount of the net assets of the subsidiary determined in accordance with IFRSs as deemed cost are as follows:

    a. ***Goodwill***. This approach does not allow for the inclusion of goodwill in the carrying amount of the net assets of the subsidiary because to do so would be tantamount to recognising internally generated goodwill. The challenge for constituents is that many would be required to write down their investment in subsidiaries on transition to IFRSs. These respondents assert that this may present such an adverse taxation and/or legal scenario—particularly in its effect on profits available for dividend distributions—that many entities will continue to opt-out of adopting IFRSs for their separate financial statements.

    b. ***Transition dates***. Some respondents indicate that the information required to determine deemed cost according to this approach is not necessarily the same as that which is needed for the consolidated financial statements because IFRS adoption dates differ between the parent entity and the subsidiary. The implication is that, if the subsidiary is not already applying IFRSs at the date of the parent's transition to IFRSs, the preparer will be required to prepare an

IFRS balance sheet for the subsidiary at the parent's transition to IFRSs.

16. Respondents also point out a potential conflict between the guidance proposed in the ED and that which is present in IFRS 1. The ED indicates that one method of determining deemed cost is to use the interest in the carrying amount of the subsidiary's assets less liabilities, using the carrying amounts that IFRSs would require in the subsidiary's balance sheet. IFRS 1, paragraph 2, permits a subsidiary adopting IFRS at a later date than its parent to measure its assets and liabilities at either its date of transition or adopt the amounts included in the parent's consolidated financial statements, based on the parent's date of transition. Respondents have asked for clarification as to which carrying amount is being referred to in the ED.

17. Respondents also requested guidance for situations where the net asset carrying amount of a subsidiary is negative, thereby indicating an insolvent entity. Respondents have specifically requested that the Board accept a net asset carrying amount of zero in the event a subsidiary is shown to have net liabilities, regardless of the manner in which deemed cost is calculated.

Disclosure

18. Respondents expressed concern that the two permitted methods of determining the deemed cost of an investment in a subsidiary may not be comparable. These respondents request that preparers be required to disclose whether deemed cost has been elected by the first-time adopter as permitted under paragraph B5 of the ED. These respondents believe that, when the deemed cost is elected, more information should be provided to explain whether the deemed cost is based on fair value or net asset carrying amount.

Alternative approaches to determining deemed cost

19. Most respondents to Question 1 presented alternative methods for determining deemed cost. Most favoured the use of previous national GAAP. The following paragraphs present each alternative as articulated by respondents. It

should be noted that each alternative is put forth in an attempt to address either cost/benefit concerns or issues surrounding the treatment of goodwill.

Previous national GAAP

20. Many respondents took exception to the explanation provided in paragraphs BC3 and BC4 as to why previous national GAAP was dismissed as a potential source of deemed cost. The cost of an investment as determined under previous national GAAP is proposed and dismissed on the grounds that it would provide a less relevant measure than net asset value or fair value.

21. Many respondents believe previous national GAAP will likely result in the closest approximation of the cost method carrying value that would result under IAS 27, largely because that number itself is not a current value measurement. Respondents cite the purpose of IFRS 1 as the basis for their rationale: the goal of transition (together with transitional exemptions) is to result in the best approximation of an IFRS balance sheet at that date and is therefore not seeking to remeasure or update information (other than for those assets or liabilities that require such remeasurement).

22. Respondents also argue that the intended relief in the ED fails to deliver its objective because it is over-engineered for its purpose of providing a simplified methodology for first time adopters. From these respondents' perspective, permitting the use of the carrying amount under previous national GAAP is the only way to bring genuine relief with regard to determining cost under IAS 27. These respondents believe that carrying amounts determined using existing national GAAP versus those determined using the methods in the ED will result in negligible differences.

23. One respondent articulated the advantages of using previous national GAAP in the following manner:

    a. The information is readily available and its application is straightforward.

b. The use of previous national GAAP as deemed cost is consistent with existing guidance in IFRS 1 that permits the use of values for business combinations that are based on an entity's previous GAAP.

c. Goodwill is included in the carrying amount of the subsidiary, unless it has been deducted directly from equity.

d. Impairment testing ensures the carrying amount under previous GAAP does not exceed its recoverable amount at the date of transition.

e. Many countries follow the general principles in IAS 27, indicating that the previous GAAP amount ought to provide information that is as useful as the two methods proposed in the ED.

f. Legal and/or tax difficulties will be mitigated.

24. Some respondents that support the use of previous national GAAP as deemed cost for determining the cost of an investment in a subsidiary concede that some jurisdictions may be using a previous national GAAP whose principles bear little resemblance to those espoused by IAS 27. In this instance, deemed cost determined using previous national GAAP would possess little information content.

Previous GAAP equity accounting

25. A few respondents advocated consideration of the use of previous GAAP equity accounting for determining the cost of an investment in a subsidiary. The primary justification for this approach is to address the issue of goodwill. Under the equity method, the investment in the subsidiary is initially recognised at cost (which includes goodwill) and the carrying amount is increased or decreased to recognise the parent's share of profit or loss after the date of acquisition.

26. These respondents also indicate their understanding that equity accounting is not based on the same general principles as IAS 27.

The higher of the previous GAAP carrying amount of the investment and the net asset value (as determined under the provisions of the ED) as deemed cost

27. Respondents that support this approach to determining deemed cost believe it balances the Board's concern that an entity's previous GAAP number may bear little resemblance to cost in accordance with IAS 27 with respondents' concern that the net asset approach articulated in the ED will require some parents to write down their investment in a subsidiary on the date of transition to IFRSs because it does not take goodwill into account.

28. Respondents that do not support this approach believe it amounts to an arbitrary comparison of two numbers prepared on different bases.

The net asset value of the subsidiary (as determined under IFRSs) with historical goodwill included as deemed cost

29. Respondents that support this approach do so because it includes goodwill in the net asset carrying value of the subsidiary. The basis for taking this approach to determining deemed cost is premised on consistency with paragraphs in IFRS 1 that permit the use of values for business combinations that are based on an entity's previous GAAP.

The net asset value of the subsidiary (including goodwill) included in the consolidated financial statements as deemed cost

30. Respondents that support this approach believe the parent entity should be allowed to use as deemed cost the transition date net carrying amount of the subsidiary—including related goodwill—included in the consolidated IFRS financial statements. This net carrying amount would be adjusted for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary.

Question 2

The cost method in IAS 27 requires a parent to recognise distributions from a subsidiary as a reduction in the cost of the investment to the extent they are received from the subsidiary's pre-acquisition profits. This may require a parent, in some cases, to restate the subsidiary's accumulated profits in accordance with IFRSs at the acquisition date.

Such a restatement would be tantamount to restating the original business combination, requiring judgements by management about past conditions after the outcome of the transaction is known.

This Exposure Draft proposes a simplified approach to determining the pre-acquisition accumulated profits of a subsidiary for the purpose of the cost method in IAS 27. Is this appropriate? If not, why?

31. Question 2 appears to have elicited the strongest negative response from constituents, largely because many perceive the crux of the problem to be a fundamental flaw of IAS 27—not a first-time adoption issue. This concern is touched on in paragraph 8 of this paper. Many of the respondents that were able to set aside their issues with IAS 27 expressed general support for the relief proposed in the ED.

Characterization of a subsidiary's accumulated profits

Accumulated profits as "pre-acquisition"

32. Many respondents to Question 2 took the position that entities that can determine pre-acquisition profits in accordance with IAS 27 should do so.

33. For those who are unable to determine pre-acquisition profits in accordance with IAS 27, many respondents supported the ED's requirement that the accumulated profits of the subsidiary at the parent's date of transition to IFRS should be deemed pre-acquisition accumulated profits.

34. Respondents affirm that this approach prevents a parent from recognising the subsidiary's profits that were earned after its acquisition but before the parent's transition to IFRSs, twice—once on restating the investment in the subsidiary to deemed cost (measuring the deemed cost using either the net

assets or the fair value of the subsidiary) and again in income (when distributions from the subsidiary were received).

A potential "double-debit" issue

35. One respondent indicates that the proposal in the ED does not take into account that the adoption of the IFRS net asset value approach will very often result in a reduction in the carrying amount of the investment due, in large part, to the exclusion of goodwill. Companies in this situation may in fact suffer a "double debit" rather than a "double credit".

36. The example given by the respondent is a subsidiary that has substantial accumulated profits at the date of transition which are known to have been earned post-acquisition. However, its parent may have to use the deemed cost exemption because it is unable to determine whether any dividends were received out of pre-acquisition profits many years ago and credited to income. The parent's cost of investment is based on fair value at the date of acquisition. If the parent elects to use IFRS net asset value as deemed cost, it will first suffer a debit to equity on transition. It will also be unable to record as income the receipt of dividends out of the post-acquisition profits of its subsidiary resulting in a further reduction in equity compared with what it would have been if the exemption had not been used.

37. The solution proposed by the respondent is an amendment to B6(a) to state that when the deemed cost exemption is used, all dividends subsequently received are deemed to be out of post-acquisition profits, subject to a requirement to test the investment for impairment. An alternate solution is to indicate that profits should be regarded as pre-acquisition only to the extent that the deemed cost is higher than the previous GAAP carrying amount. This approach avoids the "double credit" problem identified in BC8 without creating a "double debit" issue for other companies.

Accumulated profits as "post-acquisition"

38. For those that are unable to determine pre-acquisition profits in accordance with IAS 27, some respondents believe that all retained profits should be

treated as post-acquisition at the date of transition and recognised as income, up to the maximum amount that could be distributed without resulting in an impairment of the cost of the investment.

39. The logic given for this approach is that the previous GAAP carrying amount represents a cost based measure in most cases. If a dividend results in the impairment of that cost then it implies that it has been paid out of pre-acquisition profits. Some respondents believe this approach is practical to apply at transition and will prevent an incremental negative effect on the ability of groups to make distributions to shareholders. Because preparation of separate financial statements is mainly driven by local legal and distributable profits requirements, allowing some flexibility in the determination of pre-acquisition profits may encourage more companies to fully adopt IFRS.

SPECIFIC COMMENTS—EDITORIAL SUGGESTIONS

Location of amendment in IFRS 1

40. Several respondents proposed alternative locations for this amendment to IFRS 1. Each suggestion is presented below:

    a. The issues addressed in the Exposure Draft are not concerned with business combinations in the sense that the term is defined in IFRS 3 therefore the relief should not be located in Appendix B. The exemption should be relocated to the body of IFRS 1 to avoid any doubt regarding scope.

    b. Position the proposed amendment to IFRS 1 in the standard section near to the material to which it is closely related (i.e., the material in paragraphs 24 and 24 on "Assets and liabilities of subsidiaries, associates and joint ventures").

    c. Another suggestion is the creation of an Appendix C to house content on preparing separate financial statements on first-time adoption.

Revise IG Example 9B

41. Some respondents believe that IG 9B would be more useful if it illustrated the situation of a vertical group (i.e., X owns Y which owns Z) instead of a horizontal group (i.e., Y and Z are both direct subsidiaries of X). In particular, respondents indicate that it would be helpful if the example could confirm that, in the case of a vertical group, it is not necessary to perform a sub-consolidation at each level but that an aggregation of the separate financial statements net assets of the subsidiaries is all that is required.

TABLE—RESPONDENTS BY TYPE AND GEOGRAPHIC AREA

42. [Table omitted from observer note].