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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:	**September 2007, London**
Project:	**Amendments to IFRS 1**
Subject:	**Amendments to IFRS 1 Redeliberations: Cost of an Investment in a Subsidiary (Agenda paper 5)**

Introduction and summary of recommendations

Introduction

1. Paragraph 37 of IAS 27 *Consolidated and Separate Financial Statements* requires a parent to account for investments in subsidiaries in its separate financial statements either:
   (a) at cost, or
   (b) at fair value in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

2. The exposure draft of amendments to IFRS 1 (paragraph B5) proposes to allow a parent, at its date of transition to IFRSs, to use the following as deemed cost for an investment in a subsidiary in its separate financial statements:
   (a) its 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; or
   (b) the fair value of the investment in the subsidiary.

3. The ED (paragraph B6) also proposes the following simplified approach to determining the pre-acquisition accumulated profits of a subsidiary for the purpose of applying the cost method in IAS 27:

   (a) when a parent measures an investment in a subsidiary using a deemed cost in accordance with paragraph B5, the parent shall, at the date of transition to IFRSs, treat that subsidiary's accumulated profits under IFRSs as pre-acquisition accumulated profits;

   (b) a parent shall, for subsidiaries that have not been measured in accordance with paragraph B5, either:

      (i) determine the pre-acquisition accumulated profits of each subsidiary under IFRSs, or

      (ii) treat the pre-acquisition accumulated profits of each subsidiary under previous GAAP as the pre-acquisition accumulated profits under IFRSs.

4. Many respondents expressed concern that the proposals do not reduce the cost of adopting IFRSs in the separate financial statements of a parent sufficiently to justify adoption. The majority of respondents prefer that deemed cost be the carrying amount of the subsidiary calculated in accordance with previous national GAAP. Recurring themes articulated in the comment letters are that:

   (a) any method for determining deemed cost that results in a reduction in the carrying amount of the investment in the subsidiary in the parent entity's separate financial statements is unworkable; and

   (b) the definition of the cost method, which refers to 'accumulated profits', is also discouraging companies from making the transition to IFRS notwithstanding the relief proposed in the ED.

Summary of recommendations

5. The staff recommends that IFRS 1 and IAS 27 be amended so as to:

   (a) permit a deemed cost on the basis of the acquisition date fair value of the shares in the subsidiary;

   (b) permit a deemed cost on the basis of either (i) the net assets of the subsidiary as they would be reported in the consolidated financial statements; or (ii) the carrying amount of the investment under previous national GAAP;

(c) extend the deemed cost exemption to include the initial measurement of associates and joint ventures, on transition to IFRSs; and

(d) remove from IAS 27 the definition of the *cost method*. (The staff is recommending a consequential amendment to IAS 18 *Revenue* also be made in line with that proposal).

6. Given the extent of the changes from the ED, the staff recommends that the proposals be re-exposed.

7. In July the Board directed the staff to draft an amendment to IAS 27 to clarify that paragraph 37 does not apply to the formation of a new parent entity for an existing group when there are no changes in substance resulting from the revised organisation structure. The Board tentatively decided that such reorganisations should be accounted for by reference to existing carrying amounts. The revised ED would also include this amendment.

Deemed cost

Initial deliberations

8. In many jurisdictions (including most EU member countries) listed companies have a choice of preparing the separate financial statements of parent entities in accordance with either local GAAP or IFRSs. Many entities have continued to use local GAAP. The reason most often cited for this is the need to apply the IAS 27 cost method for investments in subsidiaries with full retrospective effect. Many argue that this requirement is at best, expensive in terms of time and money even if the necessary records are still available and, at worst, impracticable.

9. The use of merger relief accounting in the United Kingdom and other countries is a particular case in point. 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 a nominal value. This nominal value is viewed by most respondents as not being in accordance with IAS 27, which requires the investment to be measured initially at cost. Respondents view cost, as stated in IAS 27.37, as being an exchange value.

10. Upon transition to IFRS a company would be required to restate the cost of its investment in a subsidiary to ensure compliance with IAS 27. This would involve identifying the fair value of the investment at the date the subsidiary was acquired and then adjusting for any dividends that had been received from pre–acquisition retained earnings. Putting aside, for the moment, the matter of the dividends from pre-acquisition retained earnings, measuring this initial value is difficult when the fair value of the initial consideration has not been recorded and the consideration given was shares in an unlisted company for which no historical market value data exists. In this context the company would be required to revisit the initial acquisition and reconstruct the fair value to determine the cost of the acquisition.

11. As a result of its initial deliberations, the Board decided that the most appropriate form of relief is to allow a deemed cost. The first option is for a parent company to align the carrying amount of an investment in a subsidiary with its IFRS-compliant net asset position at the parent company's date of transition to IFRSs. The second option is to measure the fair value of the investment in the subsidiary—with that fair value being a deemed cost rather than requiring the parent to continue to measure the investment in the subsidiary at fair value.

12. By aligning the cost of the investment in a subsidiary with its underlying net asset position, the Board thought users of the financial statements would be able to identify the IFRS net asset position of the subsidiary to which the investment relates, thereby providing them with relevant information about the financial position of the subsidiary at the date of transition.

Comment letter summary

13. Respondents were not, generally, supportive of the net asset approach. The main reason is the possibility that, for those entities that currently show a carrying amount that reflects a cost including intangible assets and goodwill not currently recognised in the subsidiary's financial statements under IFRSs, the use of the net asset option could result in a reduction to their initial cost because these intangible assets would be stripped out of the final cost figure. 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.

14. Respondents to the ED were consistent in their request for the Board to reconsider allowing the use of previous national GAAP as deemed cost. The Board rejected that option in developing the ED. Respondents also expressed their belief that, as currently written, the proposals in the ED will not encourage entities to adopt IFRSs for their parent entity separate financial statements.

Analysis

15. It is clear from the comments received during due process that the proposed relief, while helping a portion of the constituency for which it is intended, falls short. Respondents clearly indicate that the risk of adverse effect on both a company's distributable reserves (and therefore its ability to pay dividends and redeem shares) and on its net assets outweighs any benefit that may be gained from discontinuing the use of previous national GAAP in favour of full adoption of IFRSs for the separate financial statements.

16. The staff asks the Board to consider the following three options:

    (i) continue with a modified 'net asset' exception;

    (ii) accept previous national GAAP as deemed cost; or

    (iii) discontinue the project.

Continue with a modified 'net asset' exception

17. Whilst the staff acknowledges that some constituents will be helped by the proposals in the ED as they are currently written, it makes little sense to continue with the proposed relief in its current form if the constituency for which it is intended largely declines to use it. The point of this project is that the cost of adopting IFRSs appears to exceed the benefits for many entities and that the relief proposed is intended to lower that cost.

18. Whilst the staff does not recommend proceeding with the ‘net asset’ approach in the ED, the staff believes that the approach can be modified to respond to respondents’ concerns about reducing the carrying amount of the investment.

19. When this issue was first considered by the IFRIC, one alternative suggested by the staff was to allow the parent to use a deemed 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. The deemed cost would be calculated based on the amounts of the underlying assets and liabilities of the subsidiary in the consolidated financial statements at the date of transition to IFRSs. Accordingly the deemed cost would reflect goodwill related to the subsidiary.

20. Based on the comments received, the staff asks the Board to reconsider this alternative. As the staff noted previously, the proposed exemption would be consistent with the principle behind the relief that IFRS 1 provides to stop an entity from having to keep parallel records. Paragraph 25 of IFRS 1 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.

21. In addition, the deemed cost would be based on the numbers that the entity is using for its consolidated accounts. As a result, the costs of complying with the exemption should be low.

Accept previous GAAP as deemed cost

22. Retaining the previous GAAP cost of an investment in a subsidiary on transition to IFRSs is the simplest option to the issues faced by constituents. Additionally, this option does not create any jurisdictional legal or tax difficulties and would be readily accepted by constituents.

23. Allowing the previous GAAP carrying amount of an investment in a subsidiary is also consistent with the exemption provided to restating business combinations in IFRS 1. That is to say, it relieves the entity from having to recreate data at the date of acquisition and transition.

24. 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.

25. This option is likely to result in a measured cost that has low information content where nominal values were used to measure cost. For example, in situations where merger relief has been used, the cost under previous GAAP represents a nominal amount relating to the number of shares issued as consideration for the acquisition of a subsidiary. This amount holds little information value to users.

26. Whilst more useful information could be obtained by other methods of relief, respondents argue that unless these methods have an on-going re-measurement requirement, it is difficult to see the usefulness of this information to users of future financial statements (as the amounts will lose their relevance in the same way as historical cost).

27. Respondents acknowledged the IASB's concern over both the lack of relevance and the potential lack of comparability between entities if previous GAAP is permitted as a deemed cost. However, they also argued that even though the previous GAAP carrying amount may not be cost as defined by IAS 27, in many cases it is still a relevant cost based measure to both the group and the current holding company.

28. The staff notes that IAS 27.42 requires a parent entity that elects or is required to prepare separate financial statements to identify the financial statements to which they relate. Therefore little information risk exists that the amounts contained in the separate financial statements of the parent entity will be viewed out of the context provided by the consolidated financial statements.

29. Any carrying amount that varies from what would be recognised under previous GAAP presents a series of problems for constituents. Constituents' must comply with jurisdictional requirements that may be made more punitive by rule-based accounting treatments. For companies whose dividend distribution

policy is governed by local law, a switch to a carrying amount other than what has historically been used may have the result of restricting the distribution of dividends. This situation deters companies from adopting IFRSs in the separate financial statements of their parent entities.

Discontinue the project altogether

30. The staff believes that it would be inappropriate to discontinue the project at this stage. Respondents were nearly universal in affirming the need for relief in determining the cost of an investment in a subsidiary for purposes of the parent only separate financial statements—they simply were not wholly satisfied with the proposed solutions in the ED.

Staff recommendation

31. IAS 27 requires a parent to account for investments in subsidiaries in its separate financial statements either a) at cost; or b) at fair value in accordance with IAS 39. In the original ED, the Board proposed relief from this requirement for first-time adopters of IFRSs in the separate financial statements of the parent entity. The original relief allowed preparers to use a deemed cost consisting of either a) the net asset value the subsidiary calculated using the carrying amounts that IFRSs would require in the subsidiary's balance sheet; or b) the fair value of the investment in the subsidiary.

32. After considering feedback from respondents, the staff proposes the following revised proposal:

> An exception on transition to IFRS be provided which permits a parent to measure the investment in the subsidiary as a deemed cost on the basis of:
>
> (a) Fair value; or
>
> (b) Either:
>
> (i) net assets calculated based on the amounts of the underlying assets and liabilities of the subsidiary in the consolidated financial statements (not the subsidiary's financial statements) at the date of transition to IFRSs; or

(ii) previous carrying amount.

33. The staff is split as to its preference with regard to options (b)(i) and (b)(ii) as deemed cost. On balance, there are compelling arguments to accept either (but not both) option as deemed cost. The staff thinks the first approach is technically superior and is consistent with the principles in IFRS 1. The second approach, while arguably less grounded in conceptual rigour, is a practical way to help constituents make the full transition to IFRSs for all of their financial statements.

Question for the Board

34. *Which option for deemed cost does the Board support?*

(a) Option 1: Net assets calculated based on the amounts of the underlying assets and liabilities of the subsidiary in the consolidated financial statements (not the subsidiary's financial statements) at the date of transition to IFRSs.

(b) Option 2: Previous carrying amount.

Distributions (the cost method)

35. The definition of the cost method in IAS 27.4, which was added into IAS 27 as part of the improvements project, is:

> 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.

36. As a consequence, IAS 27 requires distributions received in excess of profits arising after the date of acquisition (referred to as dividends out of *pre-acquisition* profits) to be regarded as a recovery of the investment and therefore accounted for as a reduction of the cost of the investment (IAS 27, paragraph 4). This requirement is at the heart of two difficulties that the ED was designed to address.

37. The first issue is that, even if the parent is able to identify the cost of the original investment in the subsidiary, the parent is required to assess dividends after the subsidiary was acquired to determine if they are in excess of accumulated profits after the date of acquisition. The inability to access information to make that assessment was one of the reasons that the exception was developed, because it avoided the need to identify such dividends.

38. The second issue is that, having established a deemed cost at the date of transition, it is not always appropriate to require a parent to adjust that deemed cost down if a dividend exceeds accumulated profits after the date of transition. In most cases that dividend is not a recovery of the investment. For that reason a concession was suggested in the ED that deemed the dividends to be from post-acquisition profits.

Comment letter summary

39. Respondents were consistent in asserting that the real issue to be resolved lay in IAS 27, not IFRS 1. These respondents indicated that IFRS 1 is not the correct

venue for rectifying challenges pertaining to the task of splitting accumulated profits between pre-acquisition and post-acquisition.

40. Respondents asked the Board to consider deleting from IAS 27 the requirement for distributions received out of pre-acquisition profits to be treated as a reduction in the cost of the investment in the subsidiary. These respondents suggest that IAS 27 should 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.

41. If the Board is unwilling to accept this approach, respondents request that IAS 27.4 be reworded. The underlying principle of IAS 27.4 is that a receipt which is in the nature of a return of capital should be deducted from the cost of an investment. Respondents assert this is an economic concept that should be independent of the basis of accounting chosen by either the parent entity or the subsidiary. These respondents argue that the reference to profits in IAS 27 is inappropriate in this context and should not be restricted to profits computed in accordance with IFRSs, nor on a sub-consolidated basis. To retain the substance of the existing requirement, respondents would like the Board to consider expressing it in terms of whether the receipt is in substance a return of capital rather than linking it to profits.

42. Respondents note that a similar amendment should be considered for IAS 18 *Revenue*. IAS 18, paragraph 32 states that when dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. However, in the case of IAS 18, this rule is subject to a specific exemption where it is not possible to make such an allocation except on an arbitrary basis.

Staff analysis

43. When this issue first came to the IASB, the staff contemplated a modification to the cost method in IAS 27 as a way of providing relief. However, the staff determined this approach to be outside the scope of this particular project, which was initiated specifically to address the needs of first-time adopters.

44. The staff thinks there is merit in removing the definition of the cost method. The principle underpinning the definition is that a return of an investment should be deducted from the carrying amount of the investment. Yet, the current wording in IAS 27 creates a problem in some jurisdictions because it makes specific reference to accumulated profits as the means of making that assessment. The staff think that it be better to reword the requirements to provide a principle should meet the need of the IFRS whilst avoiding conflict with jurisdictional language and requirements.

45. An investment in a subsidiary is already within the scope of IAS 36 *Impairment of Assets*. This means that the carrying amount of an investment in a subsidiary in the parent's separate financial statements will need to be assessed for impairment in accordance with IAS 36. That requirement should reduce the risk that removing the definition of the cost method will lead to investments in subsidiaries being systematically overstated.

46. Removing the definition also avoids the need to have an exception for investments in subsidiaries that are measured at deemed cost at the date of transition. That is to say, the exception creates an additional complication that can be avoided by stepping back to a more principled approach to dividends.

Recommendation

47. **The staff recommend that:**

(a) The definition of the *cost method* be deleted from IAS 27; and

(b) Paragraph 32 of IAS 18 be amended to delete the references to dividends 'declared from pre-acquisition profits' and to state that a dividend that represents a return of an investment should be deducted from that investment, in the case of an investment in a subsidiary.

Question for the Board

48. *Does the Board agree with the staff's recommendation?*

Associates and joint ventures

49. Many respondents noted that the exemption in the ED is limited to investments in subsidiaries. These respondents indicated that identical issues arise in practice in relation to associates and jointly controlled entities. They also noted that both IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* refer to IAS 27 in their delineation of the requirements for accounting in the investor's separate financial statements. As a result, any exemption from IAS 27 should apply equally to investments in associates and jointly controlled entities.

50. Some respondents noted that, for equity accounted investments, the issues addressed in the ED are also relevant to the group financial statements. Under the equity method the investment in an associate or jointly controlled entity is recognised initially at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. Respondents request that, if the Board proceeds with an amendment to IFRS 1, the scope of the proposed amendments be extended to provide relief for the determination of the cost of investments in associates and jointly controlled entities.

Recommendation

51. The staff agrees with respondents that the proposed relief should extend to associates and jointly controlled entities. Early papers presented to the IFRIC included associates and jointly controlled entities along with subsidiaries as intended beneficiaries of the proposed relief.

Question for the Board

52. *Does the Board agree with the staff's recommendation to extend the proposed exemption to investments in associates and joint ventures?*

Due process

53. The staff believes that the nature of the changes to the ED proposed in this paper would necessitate re-exposure for the following reasons:[1]

(a) the use of previous national GAAP as deemed cost for purposes of applying IAS 27.37 in the separate financial statements of a parent entity was not originally exposed;

(b) the scope of the project has been extended to include the initial measurement of associates and joint ventures, on transition to IFRSs;

(c) the removal from IAS 27 of the definition of the cost method (along with a consequential amendment to IAS 18) must be exposed as it is a replacement for the relief that was originally proposed in the ED; and

(d) the scope exception granted to IAS 27.37 for new entities formed from an existing group when there are no changes in substance resulting from the revised organisation structure has not yet been exposed.

54. [Paragraph omitted from observer note].

Question for the Board

55. *Does the Board agree that the proposals should be re-exposed with a comment letter deadline in mid-January?*

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[1] Paragraph 47 of the Due Process Handbook states that in considering the need for re-exposure, the IASB:

- identifies substantial issues that emerged during the comment period on the exposure draft that it had not previously considered
- assesses the evidence that it has considered
- evaluates whether it has sufficiently understood the issues and actively sought the views of constituents
- considers whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions on the exposure draft.