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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:	**17 April 2008, London**
Project:	**Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate**
Subject:	**Comment Letter Summary and Analysis (Agenda paper 9A)**

INTRODUCTION

1. In its December 2007 exposure draft, *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (the ED), the Board proposed an amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* that would allow first-time adopters to use a deemed cost to account for an investment in a subsidiary, jointly controlled entity or associate in their separate financial statements. The ED proposes that an entity may choose as the deemed cost of such investments either the fair value or the previous GAAP carrying amount of the investment at the entity's date of transition to IFRSs.

2. The Board also proposed an amendment to IAS 27 *Consolidated and Separate Financial Statements* to delete the definition of the 'cost method' from IAS 27. Additionally, the ED proposes to amend IAS 27 to require an investor to recognise as income in its separate financial statements dividends received from a subsidiary, jointly controlled entity or associate. The receipt of this dividend requires the investor to test its related investment for impairment in accordance with IAS 36 *Impairment of Assets*.

3. In this paper, the staff analyses the comments received and recommends that the Board carry forward the proposals made in the ED as final amendments to IFRS 1 and IAS 27—with one exception. The staff proposes to adopt an indicator approach to the impairment test as opposed to the trigger approach reflected in the ED.

STRUCTURE OF THE PAPER

4. This paper is structured as follows:

- Background—the history of the project (paragraphs 5—23)
- Summary of general comments on the exposure draft (paragraph 24)
- Comment letter summary and analysis for proposed amendments to IFRS 1—question 1 (deemed cost) and question 2 (change in scope) from the Invitation to Comment (ITC) (paragraphs 25—31)
- Comment letter summary and analysis for proposed amendments to IAS 27—question 3 (deletion of the 'cost method') and question 4 (requirement to present dividends as income and test the related investment for impairment) in the ITC (paragraphs 32—48)

BACKGROUND

5. In March 2006, the Board added a project to its technical agenda to consider issues related to measuring the cost of an investment in a subsidiary in the separate financial statements of a parent on first–time adoption of IFRSs. The issues were divided into two categories: the determination of the initial 'cost' of an investment in a subsidiary in accordance with IAS 27.37(a) (from the 2007 IFRS Bound Volume) and the subsequent measurement of that cost in the separate financial statements of the parent to reflect dividend receipts from the subsidiary.

Determining the initial cost in accordance with IAS 27.37(a)

6. In many jurisdictions (including most EU member countries) listed entities 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, not cost beneficial in terms of time and money even if the necessary records are still available and, at worst, impracticable.

7. The use of merger relief accounting in the United Kingdom and other countries is a 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 amount. This nominal amount is viewed by many as not being consistent with the IAS 27 definition of cost. Many view cost, as stated in IAS 27.37(a), as being an exchange value.

8. Upon transition to IFRSs a parent 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. 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.

Dividend receipts from a subsidiary paid subsequent to acquisition

9. Once a parent has established the initial cost of its investment in a subsidiary, it must then determine whether any dividend receipts from that subsidiary were paid, subsequent to its acquisition, out of pre-acquisition or post-acquisition retained earnings. This requirement is the 'cost method' and it is defined in paragraph 4 of IAS 27 as:

> …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 retained earnings 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.

10. As a consequence, IAS 27 requires distributions received in excess of retained earnings arising before the date of acquisition (referred to as dividends out of *pre-*

acquisition retained earnings) to be regarded as a recovery of the investment and therefore accounted for as a reduction of the cost of the investment. This requirement is at the heart of two difficulties.

11. First, 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 retained earnings after the date of acquisition. Restating the pre-acquisition retained earnings would be a task tantamount to restating the business combination (for which IFRS 1 provides an exemption in paragraph 15 and Appendix B). It might involve subjective, and potentially selective, use of hindsight, which would diminish the relevance and reliability of the information (because it would involve making judgements about the fair values of the assets and liabilities of a subsidiary at the acquisition date).

12. Second, 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 retained earnings after the date of transition. In most cases that dividend is not a recovery of the investment. For that reason constituents requested a concession that deemed the dividends to be from post-acquisition retained earnings.

January 2007 Exposure Draft

13. In January 2007 the Board published *Cost of an Investment in a Subsidiary*, an exposure draft of proposed amendments to IFRS 1. In that ED, the Board proposed to allow the use of a deemed cost in the separate financial statements of first-time adopters for the purpose of determining cost in accordance with IAS 27.37(a). The deemed cost could be either:

- the parent's interest in the carrying amount of the subsidiary's assets less liabilities, using the carrying amounts that IFRSs would require in the subsidiary's statement of financial position; or

- the fair value of the investment in the subsidiary (determined in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*).

14. Additionally, the Board proposed to provide an exemption on transition to IFRSs from restating the retained earnings of the subsidiary at the date of acquisition for the

purpose of applying the cost method. The form of the exemption depended on whether the parent used the deemed cost option described in paragraph 13.

- If the parent used the deemed cost option, the Board proposed that the retained earnings of that subsidiary at the parent's date of transition should be deemed to be the pre-acquisition retained earnings for the purpose of applying the cost method in IAS 27.

- If the parent did not use the deemed cost option, the Board proposed that the parent could determine the pre-acquisition retained earnings in accordance with the previous GAAP carrying amount for the purpose of applying the cost method.

Redeliberations

15. The comment period for the exposure draft ended on 27 April 2007. Comments from the exposure draft were presented to the Board in June 2007.

16. The majority of respondents were not in favour of the deemed cost exemption described in paragraph 13. At issue was the fact that the net asset deemed cost option described in the exposure draft does not allow for the inclusion of goodwill in the carrying amount of the net assets of the subsidiary; to do so would be tantamount to recognising internally generated goodwill. The challenge for constituents is that some would be required to write down their investment in subsidiaries on transition to IFRSs. These respondents asserted 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.

17. During redeliberations the Board noted that it made little sense to issue the exemption proposed in the exposure draft if the constituency for which it was intended declined to use it. On the basis of respondents' comments, the Board decided that if a net asset value was used as a deemed cost, the net asset value should use the amounts that the parent incorporates in its consolidated financial statements, rather than the amounts recognised in the separate or individual financial statements of the subsidiary (as was originally proposed in the January 2007 exposure draft).

18. It was not clear to the Board, however, that this approach would address the concerns expressed by respondents. Accordingly, the Board tentatively decided that, unless it was clear that a net asset approach sufficiently reduced the cost of adopting IFRSs in the separate financial statements of parent entities, deemed cost could be measured as the carrying amount of the investment under previous national GAAP. The Board asked the staff to consult with the respondents to the exposure draft to determine whether a revised approach to calculating net assets would resolve their concerns.

19. The staff contacted the respondents to the January 2007 exposure draft and asked whether a net asset approach based on the amounts that the parent incorporates in its consolidated financial statements would be an optimal deemed cost option. Informal feedback from these respondents indicated practical difficulties still existed regardless of whether the net asset value deemed cost was based on the amounts that the parent incorporates in its consolidated financial statements or the amounts recognised in the separate or individual financial statements of the subsidiary. As a result, the staff determined that one of the deemed cost options would be to measure the amount of the investment as the carrying amount determined in accordance with previous national GAAP.

Change in scope

20. The Board also agreed with respondents that similar issues arise in practice in relation to determining the initial cost of an investment in jointly controlled entities and associates. Both IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* refer to IAS 27 in their description of the requirements for accounting in the investor's separate financial statements.

Removal of the 'cost method'

21. The Board also redeliberated its proposals regarding a simplified approach to determining the pre-acquisition retained earnings of a subsidiary for the purpose of applying the cost method in IAS 27. Even though the Board had made concessions in the January 2007 exposure draft to the basis of valuing subsidiaries and the identification of distributions from pre-acquisition profits, many respondents indicated that the remaining restrictions in IAS 27 as to how pre-acquisition profits are determined discourage companies from making the transition to IFRS, thereby

stripping the exemption proposed in the exposure draft of any real value. These respondents suggested 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.

22. In the light of respondents' comments, the Board opted to address the requirement to assess retained earnings into pre-acquisition and post-acquisition components more generally, rather than merely providing exemption upon first-time adoption of IFRSs in the separate financial statements of the parent entity.

Re-exposure

23. The Board published a second exposure draft: *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* on 13 December 2007. A summary of the comments received on the Board's revised proposals (as well as staff analysis of that feedback) is presented in paragraphs 24 to 49 of this paper.

GENERAL COMMENTS ON THE EXPOSURE DRAFT

24. Overall, respondents to the ED support the Board's revised proposals with two exceptions. First, several respondents request clarification regarding the presentation of dividends as income with any associated impairment presented as an expense. These respondents ask that additional thought be given to preserving the 'return of capital' versus 'return on capital' principle embodied in the cost method (see paragraphs 35—38). Second, the majority of respondents do not support the Board's proposal to require impairment testing of the investment when a dividend is received; many prefer an indicator approach (see paragraphs 39—41).

COMMENT LETTER SUMMARY AND ANALYSIS OF PROPOSED AMENDMENTS TO IFRS 1

Question 1—Deemed cost

The exposure draft proposes to allow an entity, at its date of transition to IFRSs in its separate financial statements, to use a deemed cost to account for an investment in a subsidiary, jointly controlled entity or associate. The exposure draft proposes that an entity may choose as the deemed cost of such investments either the fair value or the previous GAAP carrying amount of the investment at the entity's date of transition to IFRSs.

Do you agree with the two deemed cost options as they are described in this exposure draft? If not, why?

Question 2—Change in scope

The exposure draft proposes that the deemed cost option should be available for the initial measurement of investments in jointly controlled entities and associates when an entity adopts IFRSs in its separate financial statements.

Do you agree with the proposal to allow the deemed cost option for investments in jointly controlled entities and associates? If not, why?

Comment letter summary: deemed cost

25. A clear majority of respondents to the ED support the Board's proposals to allow the use of a deemed cost to account for an investment in a subsidiary, jointly controlled entity or associate. Respondents were nearly universal in indicating that the proposed amendments to IFRS 1 would reduce the time and cost involved in adopting IFRS in the separate financial statements of parent companies.

26. Some respondents indicate that the previously proposed 'net asset deemed cost' method is a reasonable option that should remain in the final amendment to IFRS 1. The justification given for this is that net assets represent the underlying acquired interest of the investment therefore the information is relevant and comparable. Further, this measure is commonly used by analysts and auditors to determine an entity's 'fundamentals.'

Staff analysis: deemed cost

27. The net asset value approach to determining deemed cost was discarded during redeliberations. Practical difficulties still exist regardless of whether the net asset

value deemed cost is based on the amounts that the parent incorporates in its consolidated financial statements or the amounts recognised in the separate or individual financial statements of the subsidiary. As a result, the staff determined that one of the deemed cost options would be to measure the amount of the investment as the carrying amount determined in accordance with previous national GAAP.

28. The staff is not inclined to add the net asset value approach back into the list of options for determining deemed cost. It is the staff's view that the introduction of previous GAAP carrying amount as a deemed cost option sufficiently lowers the costs of adoption of IFRS in the separate financial statements of the parent entity; a third option is therefore not necessary.

29. The staff intend to carry forward the ED's deemed cost proposals into the final amendments to IFRS 1 with minimal drafting changes. Additionally, the staff does not plan to discuss this issue at the April Board meeting unless the Board would like to do so.

Comment letter summary: change in scope

30. Respondents who answered the question agreed unanimously with the Board's intention to expand the use of the deemed cost option for investments in jointly controlled entities and associates in the separate financial statements of investors.

Staff analysis: change in scope

31. The staff intend to carry forward the expansion of the ED's deemed cost proposals to include investments in jointly controlled entities and associates into the final amendments to IFRS 1. Additionally, the staff does not plan to discuss this issue at the April Board meeting unless the Board would like to do so.

COMMENT LETTER SUMMARY AND ANALYSIS OF PROPOSED AMENDMENTS TO IAS 27

Questions 3 and 4—Cost method

The exposure draft proposes to delete the definition of the 'cost method' from IAS 27. Additionally, the exposure draft proposes to amend IAS 27 to require an investor to recognise as income dividends received from a subsidiary, jointly controlled entity or associate in its separate financial statements. The receipt of this dividend requires the investor to test its related investment for impairment in accordance with IAS 36 Impairment of Assets.

Do you agree with the proposal to delete the definition of the cost method from IAS 27? If not, why?

Do you agree with the proposed requirement for an investor to recognise as income dividends received from a subsidiary, jointly controlled entity or associate and the consequential requirement to test the related investment for impairment? If not, why?

Comment letter summary: removal of the cost method

32. The majority of respondents to this question in the ED supported the Board's proposal to delete the definition of the cost method from IAS 27. Respondents indicate that applying the cost method, for both existing preparers and first-time adopters, is a significant cost burden, particularly when entities are moved within groups or are purchased from outside groups.

Staff analysis: removal of the cost method

33. The staff intend to carry forward the Board's proposal to delete the definition of the cost method from IAS 27 into the final amendments to IAS 27. Additionally, the staff does not plan to discuss this issue at the April Board meeting unless the Board would like to do so.

Comment letter summary: presentation of dividends as income and requirement to test the investment for impairment

34. Although the majority of respondents support the Board's proposal to delete the definition of the cost method from IAS 27, many question the appropriateness of the proposed accounting treatment that would replace it. Specifically, respondents are split as to whether dividend receipts should *always* be presented as income (discussed

further in paragraphs 35—38). Additionally, respondents were nearly unanimous in their rejection of the Board's proposal to require impairment testing (at the nearest reporting date) of the investment in a subsidiary, jointly controlled entity or associate when a dividend is paid to the investor (discussed further in paragraphs 39—41).

Presentation of dividends as income

35. Paragraph 37B of the ED proposes that an investor recognise income in its separate financial statements when it receives dividends from a subsidiary, jointly controlled entity or associate. Dividends are defined in paragraph 5 of IAS 18 *Revenue* as 'distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital.'

36. Several respondents observe that, in many jurisdictions, distributions of amounts other than profits can be made, such as revaluation reserves and capital reserves. The following table (taken from CL #35) summarises, for a sampling of jurisdictions, elements of equity that are distributable as dividends over and above the distribution of profits.

Country	**Distributable reserve**	**How the reserve is created**
Australia	Revaluation reserve	Revalued assets
Amman	Revaluation reserve	Revalued assets
Canada	Revaluation reserve Other comprehensive income Additional paid in capital	Revalued assets Gains and losses excluded from profit Contributions from shareholders
Finland	Additional paid in capital	Contributions from shareholders
France	Additional paid in capital	Contributions from shareholders
Germany	Additional paid in capital Capital reserve	Contributions from shareholders Contributions from shareholders
Ireland	Additional paid in capital	Contributions from shareholders
Netherlands	Additional paid in capital	Contributions from shareholders
Norway	Other contributed capital	Purchase and sale of treasury shares
Romania	Revaluation reserve	Revalued assets
Spain	Additional paid in capital	Contributions from shareholders
UK	Capital contributions in cash (other than for shares)	Contributions from shareholders

37. One respondent points out that the removal of the cost method may make the debate as to whether distributions of other elements of equity are from 'profits' or not, particularly relevant.

> The removal of the definition of the cost method means that the accounting treatment for distributions other than profits (or post-acquisition profits as in the current IAS 27) is no longer stated. [T]he removal of this definition will probably result in different approaches as to how such distributions are accounted for—by analogising to the proposed change, or recognising these as a reduction of the investment. [CL #35]

38. Additionally, a few respondents claim that, in some jurisdictions, legislation prohibits the recognition of dividends paid out of pre-acquisition profits as income.

> In certain jurisdictions (such as Ireland), legislation prohibits the recognition of dividends, out of pre-acquisition profits, as income (for good creditor protection reasons). Retaining the option in IFRS of adopting that treatment would avoid creating an unnecessary inconsistency between IFRS and existing local legislation, in addition to retaining the option to adopt a legitimate method of accounting for dividends out of pre-acquisition profits. The short period of time allowed for consideration of this substantial change also does not permit liaison with legislators to solve the legal issue. [CL #12]

Requirement to test the investment for impairment

39. Paragraph 37B of the ED also contains a requirement that, if an investor accounts for its investment in its subsidiary, jointly controlled entity or associate at cost in accordance with paragraph 37 of IAS 27, the receipt of such a dividend is an event that requires the investor to test the related investment for impairment in accordance with IAS 36. This requirement was added as a way to ensure that the carrying amount of the investment is not overstated.

40. Respondents to the ED were nearly universal in expressing the view that the receipt of a dividend from an investment in a subsidiary, jointly controlled entity or associate should **not** be an event that **requires** an investor to test the related investment for impairment in accordance with IAS 36. Many respondents believe that such a requirement would be both unduly burdensome and unnecessary. These respondents prefer that the receipt of such a dividend be viewed as a possible indicator of impairment (as opposed to being characterised as an automatic trigger requiring an impairment test).

41. In circumstances where a parent company has subsidiaries, jointly controlled entities or associates that have a history of profitability—and such companies have a history

of paying a reasonable level of dividends from profits—respondents indicate that it is not appropriate that an impairment test would have to be performed without any other indicators of impairment being present. These respondents argue that the approach to impairment testing outlined in the ED represents a departure from the basic principle of IAS 36 that the recoverable amount of an asset should be measured whenever there is an indication that the asset **may** be impaired. Consequently, these respondents believe that the right to receive a dividend is not, in and of itself, enough to trigger impairment testing.

Staff analysis: presentation of dividends as income and requirement to test the investment for impairment

42. The underlying principle of the approach proposed in paragraph 37B of the ED is that dividends received from a subsidiary, jointly controlled entity or associate generate income in the separate financial statements, provided the dividend does not cause the value of the investment to fall below its carrying amount.

43. This introduces a two step process for the recognition of dividends whereby, 1) income is recognised and 2) the related investment is tested for impairment. This principle should be applied to all distributions, regardless of their source (including capital), such that all distributions are recognised as income with an impairment test being conducted. The legal label attached to that part of equity that is distributed may differ from jurisdiction to jurisdiction however this should not affect the accounting.

44. The counter argument is that, if the distribution is in effect a capital reduction, then it represents a return of the investment and therefore should not give rise to income. One approach is to draw a distinction between capital and non-capital distributions (rather than a distinction based on profits), and require only non-capital distributions to be recognised as income. This approach requires a robust definition of 'capital' to make this distinction workable across numerous jurisdictions and ensure that distributions that are effectively a form of disguised capital reductions are being captured. Additionally, guidance on the accounting for the return of capital would also be required.

45. The staff appreciate the point that distributions representing a recovery of part of the cost of an investment should not result in the recognition of income in the separate

financial statements. However, defining capital and non-capital distributions is beyond the scope of this project. Further, the staff believe the extent to which profits are distributable is really a matter of jurisdictional legislation.

46. The staff recommends retaining the proposal that all dividends receivable from a subsidiary, jointly controlled entity or associate be recognised as income in the separate financial statements of the investor. If an investor chooses to account for its investment in a subsidiary, jointly controlled entity or associate at fair value (as opposed to cost) in accordance with IAS 27.37, the investor will be required to follow the presentation requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. Consequently, the dividend receipt will be recognised as income; in the event of an impairment, any cumulative loss that had been recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment even though the investment has not been derecognised. This gross approach to presentation is mirrored in the ED's proposals: dividends are recognised as income with any associated impairment presented separately. Regardless of whether an investor chooses to account for its investment in a subsidiary, jointly controlled entity or associate at cost or fair value, the presentation of the result will be the same.

47. Additionally, the staff propose to modify the impairment requirement in paragraph 37B of the ED so that an investor's right to receive a dividend from a subsidiary, jointly controlled entity or associate may be an indicator of impairment—no longer will it automatically trigger an impairment test at the nearest reporting date. To accomplish this, the staff intend to add a paragraph in the '*Identifying an asset that may be impaired*' section of IAS 36 to indicate that an investor's right to receive a dividend from a subsidiary, jointly controlled entity or associate may be an indicator of impairment, especially in circumstances where the dividend receipt (or receivable) is an amount that reduces the recoverable amount of the investment below its carrying amount in the investor's separate financial statements.

48. **In summary, the staff recommends that the Board:**

- **retain the proposal that an investor shall recognise as income in its separate financial statements dividends receivable from a subsidiary, jointly controlled entity or associate; and**
- **modify the proposal to require an impairment test of the related investment such that the right to receive the dividend may be an indicator of impairment, particularly in situations where the amount of the dividend reduces the recoverable amount of the investment below its carrying amount in the investor's separate financial statements.**

Does the Board agree with that recommendation?