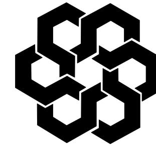

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International Accounting Standards Board

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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.

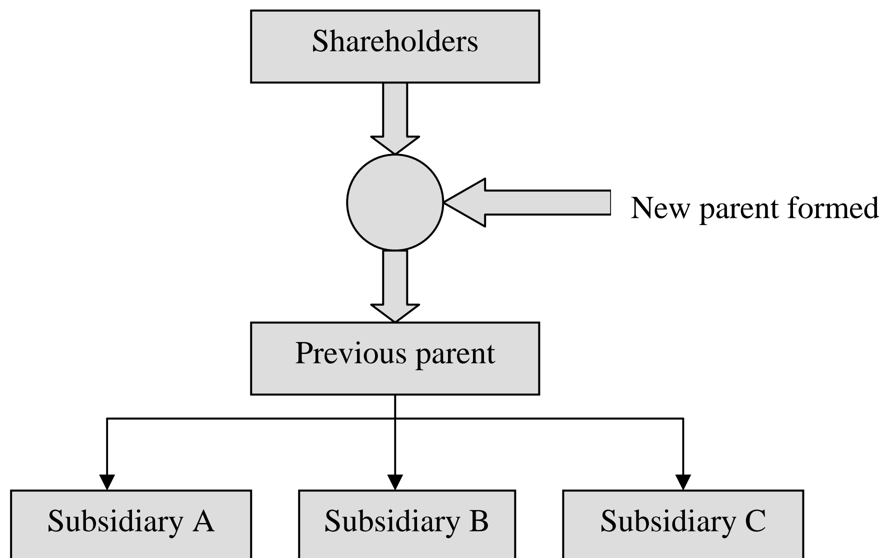
INFORMATION FOR OBSERVERS

Board Meeting:	**17 April 2008, London**
Project:	**Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate**
Subject:	**Accounting for the Formation of a New Parent: Comment Letter Summary and Analysis (Agenda paper 9B)**

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 IAS 27 *Consolidated and Separate Financial Statements* requiring a new parent formed above an existing group to measure the cost of its investment in the previous parent in its separate financial statements using the carrying amount of the equity of the previous parent.[1] This type of reorganisation is illustrated below:

[1] To simplify the language used in this paper, the staff refers to the formation of a new parent above an existing group. However, the proposed amendment would also apply to the formation of a new parent above an existing single entity (ie a standalone entity that is not part of a group).



2. In this paper, the staff analyses the comments received and recommends that the Board modify the amendment to clarify that a new parent may use either fair value or a carryover basis to measure its investment in the previous parent until the issue is addressed in the common control project.

Background

3. IAS 27 requires investments in subsidiaries to be accounted for in the parent's separate financial statements either at cost or in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

4. The Board received several enquiries about the application of this requirement to situations in which a group reorganises its operating structure by forming a new parent between itself and its existing shareholders. This type of reorganisation normally involves the new parent issuing its shares to the shareholders of the previous parent in a one-for-one exchange for their shares in the previous parent. The new parent is formed in a manner that does not change the relative ownership interests of the owners of the group and does not change the equity, assets and liabilities of the group. This type of reorganisation is of particular relevance in jurisdictions which are encouraging banks, life insurance companies and general insurers to adopt a non-operating holding company (NOHC) structure.

5. This type of reorganisation is not a common control transaction (in most circumstances). IFRS 3 *Business Combinations* states that for common control to exist the equity holders must have a collective ability to control *through a contractual arrangement*. The mere existence of common equity holders is not enough for a transaction to be a common control transaction.

6. Some interpret IAS 27 as requiring the new parent to measure its investment in the previous parent at the fair value of the previous parent at the date when the investment is made. The basis for this view is that cost is the fair value of the consideration given (ie the fair value of the shares issued by the new parent). The fair value of the shares issued by the new parent likely would be measured by reference to what was received. Accordingly, the investment in the previous parent would be measured at the fair value of the previous parent.

7. Several entities asked the Board to address new parent formations. Those entities raised the following concerns about measuring the investment in the previous parent at fair value:

    a. It is misleading to permit the net assets of the group to be remeasured simply by changing the legal structure of the group. There has been no change in the assets and liabilities of the group and the relative ownership interests in the group have not changed.

    b. The new parent might subsequently have to recognise an impairment of its investment that would not have been recognised by the previous parent. This is because the previous parent might have carried its investment at a low historical cost, whereas the new parent's investment will be at fair value. The recognition of an impairment loss would restrict the amount that the new parent could pay as dividends to its shareholders.

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

    d. The requirement to measure the group at fair value might have tax consequences in some jurisdictions.

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

8. Those entities indicated that some jurisdictions have taken steps to resolve as many of these concerns as possible, including providing taxation rollover relief and modifying corporate law restrictions on distributions to shareholders. However, they stated that the remaining concerns, especially the potential for impairment, still would be an impediment to adopting a NOHC structure.

Initial deliberations

9. In July 2007 (see Agenda Paper 6 from that meeting), the Board discussed the formation of a new parent and decided to require a new parent to measure the cost of its investment in the previous parent in its separate financial statements using the carrying amount of the equity of the previous parent.

10. The Board noted that the formation of a new parent is unique in several respects. It does not involve a transfer of resources outside of the group. The assets and liabilities of the group do not change as a result of the reorganisation. In addition, the relative ownership interests of the owners of the previous parent do not change. Finally, this type of reorganisation involves an existing entity and its shareholders agreeing to create a new parent between them. In contrast, most transactions or events that result in a parent-subsidiary relationship are initiated by a parent over an entity that will be positioned below it in the group. The Board noted that the amendment proposed would be limited to reorganisations with these characteristics.

Comment letter summary

11. This section summarises respondents' overall views on the proposed amendment and then discusses other issues raised by respondents. (See Agenda Paper 9 for an analysis of respondents by type and geographic area.)

Overall views

12. Respondents' overall views on the proposed amendment were mixed. Around half of the respondents supported the proposal. The other respondents suggested addressing the

issue in the common control project or permitting entities to choose between a carryover basis and fair value.

Support for proposal

13. Most of the respondents who agreed with the proposal noted that a carryover basis is appropriate because 'nothing has happened'. Some of those respondents agreed with the Board's basis that there has been no change in the relative ownership interests and the assets and liabilities of the group have not changed. Other respondents stated that a carryover basis is appropriate because there has been no change in the ownership of the group.

14. In addition, some respondents stated that fair value is inappropriate because an entity should not be permitted to step up its value simply by creating a new holding company. They are concerned that measuring the investment at fair value could lead to distributions to equity holders from fair value increments related to internally generated intangibles and goodwill when no external transaction has occurred. Those respondents noted that IFRSs preclude the recognition of such fair value increments in the existing parent and consolidated financial statements.

15. Several respondents were concerned that measuring the investment at fair value increases the potential for the recognition of impairment losses, which would restrict the amount that the new parent could pay as dividends to its shareholders. One respondent noted that 'The possible adverse outcomes for shareholders…would not reflect the substance of the new formation—that is, that there has been no change in the shareholders' interests in the group.' (CL 34)

16. Several respondents who supported the proposal were concerned that the amendment, as drafted, is too restrictive and as such could not be applied to many new parent formations that they believe should be included in the scope of the amendment. This issue is discussed further beginning in paragraph 24.

Address in common control project

17. Several respondents suggested that the Board address new parent formations in its project on common control transactions. Those respondents suggested that the Board should consider more broadly the principles underlying separate financial statements,

common control transactions and company reorganisations before developing guidance on the narrow issue of new parent formations.

18. Many of those respondents consider a new parent formation to be a type of common control transaction. However, even some of those respondents who identified that a new parent formation is not a common control transaction stated that the accounting is so inextricably linked that it would be better to address the issue after the Board has considered common control.

19. Some respondents were concerned that the proposed amendment pre-judges the Board's deliberations in the common control project. One respondent stated that the Board's basis for the proposed amendment could be applied to any intercompany transaction and it is too early to make that decision without considering the underlying principles more broadly. (CL 20)

20. Several respondents also were concerned that entities might apply the proposed amendment by analogy to other types of transactions. One respondent noted that the lack of guidance in IFRSs on common control transactions might lead entities to interpret the amendment widely when applying the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (CL 26). Some respondents suggested that the Board clarify in the Basis for Conclusions that the proposed amendment applies only to new parent formations and cannot be used by analogy.

Option

21. Several respondents suggested that the Board consider permitting entities to use either a carryover basis or fair value. Some of those respondents indicated that this would be an interim solution until the Board has resolved the wider issues in its common control project. Others indicated that their first preference is for the Board not to make any amendment at this time, but that their second preference would be for the Board to permit an option, rather than to require carryover basis.

22. Several respondents accepted the Board's basis for permitting the use of a carryover basis, but noted that it is difficult to justify precluding the use of fair value. Those respondents noted that a transaction has occurred and that separate financial statements are different from consolidated statements. For example, one respondent noted that the proposed amendment appears 'to ignore that separate financial statements are financial

23. Some respondents indicated that there are differing interpretations in practice about whether IAS 27 requires fair value. One respondent suggested that 'explicit clarification that IFRSs do not preclude the use of carryover basis accounting would make it clear that fair value accounting is not required, while acknowledging that the wider issue of accounting for common control transactions is yet to be resolved' (CL 26).

Other issues

Significance of 'wholly-owned'

24. As drafted, the proposed amendment applies to reorganisations in which a new parent entity is formed such that 'the existing entity becomes a wholly-owned subsidiary of the new parent'.

25. Several respondents questioned the meaning of 'wholly-owned subsidiary' and the Board's intent in using that phrase. Respondents noted that 'wholly-owned' is not defined either in existing IFRSs or in the ED and stated that different interpretations might arise in practice. For example, some might interpret 'wholly-owned' on the basis of ownership of all instruments classified as equity and others might focus only on ordinary voting rights.

26. Most respondents who commented on this issue stated that the use of the phrase 'wholly-owned subsidiary' could make the scope of the proposed amendment so restrictive that it could not be used in most new parent formations. In particular, respondents stated that it is common for entities to have preference shares (or other classes of equity with capped equity claims) that remain in the previous parent rather than being replicated in the new parent. One respondent noted that this occurs because:

    a. 'of difficulty for groups to refinance existing preference share issues or similar securities out of the new parent due to the impact of repricing and potentially restrictive covenants on these classes of equity; and

    b. if such securities were to be fully owned by the new parent and replicated by issue out of that new parent, there would be a significant and adverse loss of treatment as regulatory capital for a prudentially regulated group.' (CL 4)

27. Most respondents who commented on this issue suggested that the Board delete the reference to 'wholly-owned subsidiary'. For example, one respondent stated:

> 'Where a particular class of equity has a capped equity claim that exists both before and after the restructure, and its legal rights or economic benefits are not affected by the reorganisation, we think it should not matter, for accounting purposes, whether that equity claim is transferred to the new parent or remains with the existing entity. The fact that capped equity claims have not been replicated in the new parent reflects impositions from the regulatory environment of the banking industry, particularly in Australia. Whilst there may be matters of legal equity or shareholder approval involved, these are not accounting matters. The important aspect is that the respective claims (ie legal rights and economic benefits) of the various classes of equity are unchanged between themselves and in aggregate.' (CL 3)

28. Respondents acknowledged that the amendment has been drafted to prevent one group of shareholders from benefitting at the expense of another group without total equity changing. However, one respondent stated:

> 'There would be no breach of this objective when the interests of the class of equity that has a capped equity claim have the same claim (ie legal rights and economic benefits) before and after the restructure and there has been no alteration of the legal rights or economic interests within the class of ordinary shareholders.' (CL 3)

29. Respondents suggested that the Board also clarify the meaning of 'owners' and 'relative ownership interests' in the proposed amendment based on its clarification of 'wholly-owned'.

Application to intermediate holding companies

30. Several respondents thought that the proposed amendment is unclear about whether it applies to the formation of intermediate holding companies within a group.

31. Some respondents stated that the amendment should apply in such situations, noting that the basis for the amendment appears to apply equally to both the formation of an ultimate parent and the formation of an intermediate holding company. One respondent noted that, unless the proposed amendment applies to intermediate holding companies, the same problems that the amendment is addressing for the formation of ultimate parents would arise for newly created intermediate holding companies (CL 4).

32. Other respondents stated that the proposal should not apply to the formation of intermediate holding companies. Those respondents believe that the scope of the

proposed amendment should be limited as much as possible because of the potential for overlap with the common control project.

33. Several respondents noted that if the proposal applies to intermediate parent companies, the Board will need to clarify the measurement basis. Respondents indicated that, when a new parent is inserted above an existing subsidiary, the carryover basis used to measure the new parent's investment in the existing subsidiary could be based either on the original parent's financial statements or the subsidiary's financial statements. One respondent suggested that both alternatives be permitted until the Board addresses common control (CL 55).

Payment for shares using debt

34. Several respondents questioned the application of the proposed amendment to situations in which the new parent finances part of the purchase of the shares of the previous parent using debt. One respondent stated that the amendment should apply because there has been no transfer of resources outside of the group and the relative ownership interests do not change (CL 21). Another respondent suggested that if the Board intends for the amendment to apply only to share-for-share exchanges, it should state that fact explicitly (CL 47).

Potential issues with carryover basis

35. Respondents noted that requiring a carryover basis might create problems with the legal requirements in some jurisdictions. For example, one respondent stated:

> 'In some jurisdictions, it may be necessary to recognise the share issue at fair value for legal reasons. Where the investment is recognised at a lower amount based on the carrying amounts in the existing entity, this may result in a large debit balance in equity and the entity's net assets will be less than its share capital. This has the potential to have significant legal and regulatory implications.' (CL 46)

36. Respondents noted that this would be a particular problem in the EU. Article 15.1(a) of the EU Second Company Law Directive states that for public companies:

> 'Except for cases of reductions of subscribed capital, no distribution to shareholders may be made when on the closing date of the last financial year the net assets as set out in the company's annual accounts are, or following such a distribution would become, lower than the amount of the subscribed capital plus those reserves which may not be distributed under the law or the statutes.'

37. Therefore the proposed amendment could restrict an entity's ability to make distributions in these circumstances. This problem would be mitigated in jurisdictions that do not require the share premium to be recognised based on the fair value of the consideration received (eg under merger relief accounting in the UK).

38. Other respondents stated that in some jurisdictions there is a legal requirement to record at least the nominal value of the shares issued by the new parent. This could pose a problem if the previous parent has net assets less than the nominal value of the shares issued. One respondent suggested that the Board permit a minimum carrying value (nominal value) in that situation (CL 8). Respondents also questioned how the proposal would apply when the previous parent has net liabilities. Would the investment be measured at zero?

Other comments

39. Respondents also requested clarification of the following points. The staff does not plan to discuss these issues in detail at the April Board meeting unless Board members would like to do so. We plan to draft the amendment to clarify that:

    a. the measurement date for the new parent's investment in the previous parent is the date when the investment is made. Respondents indicated that the proposed amendment might be read as requiring measurement at the date when the new entity is formed. Respondents stated that for legal and tax reasons this might be significantly before the date that the shares are actually exchanged.

    b. the amendment addresses the measurement of a single asset (the new parent's investment in the previous parent). Respondents indicated that the proposed amendment might be read as requiring the duplication of the previous parent's equity, assets and liabilities in the separate financial statements of the new parent.

    c. the carryover basis used to measure the new parent's investment in the previous parent should reflect all of the previous parent's assets and liabilities. Respondents indicated that the proposed amendment might be read as requiring measurement based on only the carrying amounts of the previous

parent's investments in its subsidiaries, ignoring the previous parent's other assets and liabilities.

d. the proposed amendment is outside the scope of IFRS 2 *Share-based Payment*.

40. One respondent asked the Board to clarify the meaning of cost in IAS 27 and other IFRSs. The staff acknowledges that this would be useful, but we believe that it is outside the scope of the current project.

Staff analysis and recommendations

Overall approach

41. In the light of the comments received, the staff has identified three approaches the Board could choose:

    a. Approach A—proceed with the proposal in the ED to amend IAS 27 to require entities to use a **carryover basis.**

    b. Approach B—do not amend IAS 27 at this time. **Wait** and address the issue in the common control project.

    c. Approach C—amend IAS 27 to clarify that entities may use **either fair value or a carryover basis** until the issue is addressed in the common control project.

42. The staff acknowledges that, from the perspective of the group, nothing changes as a result of a new parent formation. The relative ownership interests do not change and the assets and liabilities of the group do not change. Therefore, carryover basis might be 'acceptable on the basis that the entity represented in the separate financial statements is an integral part of a larger group' (CL 26).

43. However, the staff is opposed to **requiring** carryover basis at this stage. The staff agrees with those respondents who stated that it is difficult to justify prohibiting fair value. Separate financial statements are prepared in respect of a separate legal entity. From the perspective of the new parent as a standalone entity, something has happened—the new parent has an investment that it did not have before. There has been a transaction between the new parent and the shareholders of the previous parent.

44. Therefore, the staff believes the Board should not prohibit either fair value or a carryover basis until it discusses wider issues related to separate financial statements in the common control project. The staff acknowledges that the formation of a new parent is not a common control transaction. However, the staff agrees with those respondents who stated that the issues are so inextricably linked (because they both depend on the Board's analysis of separate financial statements) that it would be better to address the formation of a new parent in the common control project.

45. The staff believes that selecting either fair value or a carryover basis at this stage might be viewed as pre-judging discussions in the common control project. This is especially worrisome because so many respondents consider new parent formations to be a type of common control transaction. Even if entities identify that a new parent formation is not a common control transaction, given the lack of guidance in IFRSs on common control transactions, it seems plausible that entities could use the IAS 8 hierarchy and apply the amendment more widely.

46. The staff acknowledges that options reduce the comparability of financial statements and generally are not desirable. However, in this situation, the staff does not believe that we are introducing a option in IAS 27. Rather, we believe that the Board would be clarifying that new parent formations are not a type of transaction that the Board contemplated when developing IAS 27 and that either fair value or a carryover basis is acceptable until the Board addresses related issues in the common control project.

47. In summary, the staff recommends that the Board choose Approach C:

a. amend IAS 27 to clarify that a new parent may measure its investment in the previous parent either at fair value or a carryover basis in its separate financial statements.

b. add the accounting for new parent formations to the scope of the common control project.

Does the Board agree with that recommendation?

Additional issues

48. If the Board decides to permit or require carryover basis, it needs to address the following additional questions raised by respondents in relation to the scope and implementation of the amendment.

Should the amendment apply when preference shares (or similar securities) remain in the previous parent? (see paragraphs 24 to 29 for a summary of related comments)

49. Many entities achieve the reorganisation described in this paper by having the new parent issue shares to the ordinary shareholders of the previous parent in exchange for their ordinary shares in the previous parent. Other classes of equity, including preference shares, remain in the previous parent.

50. The basis underlying the proposed amendment is that a carryover basis is appropriate when the equity, assets and liabilities of the group do not change and the relative ownership interests of the owners of the previous parent do not change. The staff agrees with respondents that this basis is not violated in cases in which preference shares (or other classes of equity with a capped equity claim) are not transferred to the new parent.

51. Therefore, the staff recommends that the reference to 'wholly-owned subsidiary' be deleted from the amendment.

52. Does the Board agree that the reference to 'wholly-owned subsidiary' should be deleted from the amendment?

Should the amendment apply to intermediate holding companies? (see paragraphs 30 to 33)

53. The staff recommends that the amendment **not** apply to the formation of an intermediate parent within a group. The staff acknowledges that the drafting on this point was not clear in the ED, however the Board's initial discussions of this topic were limited to the formation of an ultimate new parent.

54. The formation of an intermediate parent is a common control transaction. As noted above, there is already significant concern about entities analogising to the amendment for all common control transactions and about pre-judging the common control project. These concerns would be even more prevalent if the Board specified the accounting for one type of common control transaction.

55. Does the Board agree that the amendment should not apply to the formation of an intermediate parent company?

Should the amendment apply when the new parent finances part of the share purchase with debt? (see paragraph 34)

56. If the new parent finances the purchase of the shares of the previous parent partly with debt, the liabilities of the group change as a result of the reorganisation. One of the key aspects of the Board's basis for the proposed amendment is that the assets and liabilities of the group do not change. Therefore, the staff recommends that the formation of a new parent financed partly with debt not be included in the scope of the amendment.

57. Does the Board agree that the amendment should not apply to the formation of a new parent that is financed partly with debt?

How should carryover basis be measured when the previous parent has net liabilities or net assets less than the nominal value of the shares issued? (see paragraphs 35 to 38)

58. One respondent suggested that the Board permit entities to measure the investment in the previous parent at the nominal value of the shares issued when the previous parent's equity is less than that nominal value. The staff does not agree with that suggestion. The staff does not support introducing a third measurement basis. In addition, the staff believes that interpretation questions might arise about the meaning of nominal value. The staff also notes that entities could mitigate any issues that might arise by measuring the investment at fair value. However, the staff recommends that the amendment clarify that the investment in the previous parent should not be recognised at less than zero, even if the carrying amount of the previous parent's equity is less than zero (ie the previous parent has net liabilities). This is consistent with the general accounting for investments in subsidiaries in separate financial statements.

59. Does the Board agree that entities should not be permitted to measure carryover basis at a nominal value?

60. Does the Board agree that the amendment should clarify that the cost of the investment in a previous parent should not be recognised at less than zero?