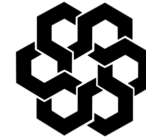

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International Accounting Standards Board

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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: **November 2008, London**

Project: **Consolidation**

Subject: **Consolidation: Sweep Issues—Transition (Agenda paper 16G)**

Introduction

1 The new IFRS on consolidated financial statements will replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*.

2 The main changes proposed in the exposure draft are:

a a new definition of control of an entity that applies to all entities.

b additional guidance relating to the application of that definition when assessing control.

c additional disclosures for unconsolidated structured entities.

3 The exposure draft does not propose changes to the accounting requirements relating to the preparation of consolidated financial statements.

4 This paper asks whether the exposure draft should include transitional provisions relating to the application of the new IFRS on consolidated financial statements.

Staff recommendation

5 We recommend that the exposure draft includes:

a transitional provisions that state that, when application of the new IFRS results in a different conclusion when assessing control from that reached when applying IAS 27 and SIC-12, a reporting entity should apply the requirements of the new IFRS prospectively from the date of first applying the new IFRS.

b disclosure requirements to provide information about the accounting consequences of the application of the new IFRS on the date of first applying the new IFRS. [Option C in the staff analysis below]

Staff analysis

6 The change to the definition of control and the additional guidance on applying that definition might result in a reporting entity reaching a different conclusion about control. Consequently, a reporting entity might be required to stop consolidating entities that were previously consolidated and start consolidating entities that were not consolidated before applying the new IFRS.

7 We think that there are four options in terms of transition:

a Option A: retrospective application

b Option B: retrospective application with an impracticability exception

c Option C: prospective application from the effective date[1]

d Option D: application in accordance with IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Option A: retrospective application

8 The change in the definition of control is similar to a change in accounting policy upon initial application of the new IFRS. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires an entity to apply a change in accounting

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[1] If the Board decides to permit early adoption of the new IFRS, the reporting entity would conduct the assessment of control on the date that it first applies the new IFRS. References in this paper to the 'effective date' refer to the date that a reporting entity first applies the new IFRS.

policy retrospectively, unless an IFRS includes specific transitional provisions relating to the change. SIC-12 *Consolidation—Special Purpose Entities* states that changes in accounting policy should be accounted for in accordance with IAS 8.

9 Retrospective application would result in the most useful information for users. An entity would be required to present its financial statements as if the new definition of control of an entity had always been in place. The information presented for all periods would be fully comparative.

10 However, retrospective application might prove to be extremely difficult, if not impossible, to apply. If a reporting entity concludes that it controls an entity that it previously did not consolidate, retrospective application would require that entity to go back and apply the acquisition method in IFRS 3 *Business Combinations* at the time that the reporting entity obtained control of the entity—control as defined in the new IFRS. This might be 3 years ago, 10 years ago or longer. The Board concluded when discussing IFRS 1 and IFRS 3 that retrospective application would not be feasible for such transactions. The new IFRS is broader than SIC-12 in that it applies to all entities. Therefore, we do not think that option A is feasible regarding the new IFRS on consolidated financial statements.

Option B: retrospective application with an impracticability exception

11 FASB's FIN 46(R) *Consolidation of Variable Interest Entities* requires retrospective application with an impracticability exception if the initial application of the requirements of the new IFRS results in the consolidation of an entity for the first time. Such an approach would mean the following:

a If the initial application of the requirements of the new IFRS results in the consolidation of an entity for the first time, on the effective date, the reporting entity recognises the carrying amounts of the assets, liabilities and non-controlling interests as if the entity had been consolidated from the date that the reporting entity obtained control of the entity (control as defined in the new IFRS).

b If it is impracticable to determine the carrying amounts of the assets, liabilities and non-controlling interests of the newly consolidated entity according to

bullet a above, the reporting entity would measure the assets, liabilities and non-controlling interests at fair value on the effective date.

c The reporting entity would adjust retained earnings in the first statement of financial position presented for any difference between the amounts recognised before and after the application of the new IFRS.

12 Providing an impracticability or 'undue cost or effort' exception makes Option B feasible, which Option A is not. However, the Board has concluded previously that we should not include such clauses in IFRSs—the Board should decide what impracticability means in particular situations and include their thinking in the requirements of IFRSs.

Option C: prospective application from the effective date

13 Option C would require a reporting entity to assess whether it controls another entity, by applying the new definition of control, as from the effective date of the new IFRS. This is consistent with the exposure draft, which requires continuous assessment of control. If, based on that assessment, the reporting entity concludes that it controls an entity that it previously did not consolidate, or vice versa, the reporting entity would begin or stop consolidation as from the effective date. In these situations, the change in control occurs on the effective date. Consequently:

a to begin consolidation, the reporting entity would apply the acquisition method in IFRS 3 as if it had obtained control on that effective date.

b to stop consolidation, the reporting entity would apply the requirements in the new IFRS relating to loss of control as if it had lost control on that effective date.

14 Option C requires a reporting entity to obtain information about the fair value of the assets and liabilities of an entity that it controls on the effective date of the new IFRS. In contrast, Option A asks for that information at the time that the reporting entity first obtained control. Option B asks for that information at the time that reporting entity first obtained control if that is possible, or if not, on the effective date of the new IFRS.

Disclosure requirements

15 If Option C is proposed in the exposure draft, we would also recommend including a disclosure requirement to provide information about the reason for the change in assessment of control, ie what factors about the relationship in the context of the new definition caused the reporting entity to conclude that it now controls another entity that it previously did not in accordance with the definition in IAS 27, and vice versa.

16 We think that it would be useful to provide information about the accounting consequences of applying the new IFRS prospectively on the effective date. However, we think that the disclosure requirements in IFRS 3 (relating to obtaining control) and in the new IFRS (relating to the loss of control) are adequate.

Option D: application in accordance with IFRS 1

17 When the initial application of the requirements of the new IFRS results in the consolidation of an entity for the first time, this creates a situation similar to the preparation of the opening statement of financial position for a first-time adopter. For example, applying the definition of control in IAS 27 might have resulted in the first-time adopter consolidating an entity for the first time on the date of transition of IFRSs. Therefore, Option D would propose that if the initial application of the requirements of the new IFRS results in the consolidation of an entity for the first time, the reporting entity measures the assets, liabilities and non-controlling interests of that entity in accordance with IFRS 1.

18 The general principle in IFRS 1 is that assets and liabilities should be measured on the basis required by the relevant IFRSs. IFRS 1 provides some exemptions and exceptions to that principle. For example, and entity may use fair value or revaluation as deemed cost for items of property, plant and equipment.

19 The reporting entity would adjust retained earnings in the first statement of financial position presented for any difference between the amounts recognised before and after the application of the new IFRS, as would be the case if the new IFRS were applied retrospectively.

20 The requirements in IFRS 1 were designed for a specific purpose—the application of IFRSs by entities that have not previously applied IFRSs. The new IFRS on consolidated financial statements is different—it applies to entities that prepare financial statement in accordance with IFRSs. We think that it would be inappropriate to apply the requirements in IFRS 1 to a situation other than the one that it was designed to address.