Project **Consolidation**

Topic **Transition Guidance**

Please note this paper is identical to Agenda paper 4F from the main April joint meeting. No changes have been made. All references within are made to the paper number from the main April joint meeting

Introduction

1 ED 10 *Consolidated Financial Statements* proposes prospective application of the amended consolidation and disclosure requirements and provides transition guidance for when a reporting entity applies the proposals for the first time. The purpose of this agenda paper is to analyse whether those proposals should be amended taking into account respondents' comments to ED 10 and the transition requirements in Statement No. 167 *Amendments to FASB Interpretation No. 46(R)*.

2 This paper:

(a) explains the transition guidance in paragraph 810-10-65 of the ASC and ED 10;

(b) summarises respondents' comments on the proposed transition guidance in ED 10; and

(c) discusses the transition requirements when a reporting entity concludes that, because of the revised consolidation requirements, it must:

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(i) consolidate a previously unconsolidated entity; or

(ii) deconsolidate a previously consolidated entity.

Statement 167 amendments transition requirements

3 The Statement 167 amendments to Subtopic 810-10 contain the following transition guidance:

(a) When an enterprise is required to consolidate a variable interest entity that it previously did not consolidate the initial measurement of assets, liabilities and non-controlling interests depends on whether it is practicable to determine carrying amounts as set out in this paragraph. If practicable, the initial measurement of the assets, liabilities and non-controlling interests of the variable interest entity is their carrying amounts at the date the revised requirements first apply. The carrying amount is the amount at which the assets, liabilities and non-controlling interests would have been carried in the enterprise's consolidated financial statements if the revised requirements had been effective when the enterprise first met the conditions to be the primary beneficiary (ie as if acquisition accounting had been applied when the conditions were first satisfied).

(b) If determining the carrying amounts as set out above is not practicable, the assets, liabilities and non-controlling interests are measured at fair value at the date the revised requirements first apply. However, if the activities of the variable interest entity are primarily related to securitisations or other forms of assets-backed financings and the assets of the entity can be used only to settle obligations of the entity, then the assets and liabilities of the entity may be measured at their unpaid principal balances at the date the revised requirements first apply. In addition, an enterprise can choose to elect the fair value option provided

by FASB Statement No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities* as long as the fair value option is elected for all of the variable interest entity's eligible financial assets and liabilities.

(c) Any difference between the net amount added to the balance sheet and the amount of any previously recognised interest in the newly consolidated variable interest entity is adjusted against equity.

(d) When an enterprise is required to deconsolidate a variable interest entity because of the revised requirements it measures any retained interest at its carrying amount. In this case *carrying amount* refers to the amount at which any retained interest would have been carried in the reporting entity's financial statements if the new requirements had been effective when the reporting entity became involved with the VIE or no longer met the conditions to be the primary beneficiary. Any difference between the net amount removed from the balance sheet and the amount of any retained interest is adjusted against equity.

(e) Comparative information may be restated for one or more years with a cumulative-effect adjustment to opening retained earnings for the first period subject to restatement.

Proposed transition requirements in ED 10

4 ED 10 proposes prospective application of the new consolidation and disclosure requirements. Earlier application is permitted. ED 10 proposes the following transition guidance:

(a) When application of the requirements of ED 10 results in the reporting entity consolidating an entity that was previously not consolidated, the reporting entity applies IFRS 3 *Business Combinations*. The date of first applying ED 10 is the deemed acquisition date, unless the acquisition date as defined in IFRS 3 is after the date of first applying the

requirements of ED 10. (So the initial carrying amounts would be fair values as at the date of first applying the new requirements).

(b) When application of the requirements of ED 10 results in a reporting entity no longer consolidating an entity that was previously consolidated, a reporting entity applies the requirements of ED 10 relating to the loss of control on the date of first applying the requirements in ED 10, unless the date of losing control is after the date of first applying those requirements.

Responses to ED 10

5 Most respondents who commented on the transition guidance asked the IASB to grant a long transition period that would allow them to implement the necessary system changes. One respondent thought that with a sufficiently long transition period retrospective application of the proposed requirements would be feasible and preferable.

6 Respondents also welcomed the proposal to allow earlier adoption of the proposed requirements. In their view, earlier adoption of the revised standard would prevent first-time adopters of IFRSs from having to apply the revised consolidation requirements shortly after they have adopted IFRSs.

7 However, respondents asked the IASB to clarify the following application issues:

(a) The transition guidance refers to the acquisition method in IFRS 3. How should a reporting entity apply the requirements in IFRS 3, when the reporting entity did not transfer any consideration at the deemed acquisition date? Does the proposed transition guidance imply that a reporting entity must fair value its interest in the subsidiary at the deemed acquisition date? Is the acquisition date deemed to be at the beginning of the first period presented or at the beginning of the current reporting period? Also, should any differences between the amount added to the

statement of financial position and any previously held interest be offset against equity or be recognised in profit or loss?

(b) The proposals in ED 10 might require a reporting entity to consolidate another entity that does not meet the definition of a business. Therefore, the requirements in IFRS 3 would not apply. Did the IASB intend the acquisition method to apply to those entities?

(c) IFRS 1 allows first-time adopters to recognise in the consolidated financial statements of the reporting entity for a subsidiary that it previously did not consolidate the subsidiary's assets and liabilities at the carrying amounts as in the IFRS financial statements of the subsidiary. The deemed cost of goodwill equals the difference at the date of transition to IFRSs between (i) the parent's interest in those carrying amounts; and (ii) the cost in the parent's separate financial statements of its investment in the subsidiary. If the parent did not acquire the subsidiary in a business combination it does not recognise goodwill.

Some respondents thought that the proposals in ED 10 were inconsistent with the requirements for first-time adopters and asked the IASB to allow a reporting entity on transition to apply either the requirements in IFRS 3 or IFRS 1.

8 Finally, respondents asked the IASB to provide illustrative examples on how the proposed transition guidance should be applied.

Staff analysis

Prospective application

9 The IASB proposed prospective application of the requirements in ED 10 (such that a newly consolidated entity would only be consolidated from when the new

requirements are first applied) because it did not think that the retrospective consolidation or deconsolidation of another entity would be feasible.

10 We believe that this conclusion is consistent with the decisions that the boards have made in both their joint business combinations project and their respective fair value measurement projects.

11 In their joint project on business combinations the boards decided that the acquisition method in IFRS 3 and Topic 805 must be applied prospectively because retrospective application would not be feasible. At that time, the boards also decided to prohibit voluntary retrospective application of the revised requirements to ensure comparability between different business combinations.

12 Similarly, the IASB has concluded during its deliberations of ED/2009/5 *Fair Value Measurements* that the proposals should be applied prospectively. The IASB decided against retrospective application because it believed that a change in the methods used to measure fair value would be inseparable from a change in the fair value measurements (ie as new events occur or as new information is obtained, eg through better insight or improved judgement). When the FASB issued Statement No. 157 *Fair Value Measurements* it came to the same conclusion.

13 Therefore, we recommend that the boards affirm that a previously unconsolidated subsidiary that would be required to be consolidated under the new requirements only be required to be consolidated from the date of application of the new requirements.

14 The question then arises as to what is the best way to initially measure the assets and liabilities of the newly consolidated subsidiary at the date of first applying the new consolidation standard. As outlined below, we propose that, if practicable, the initial measurement of the new subsidiary's assets, liabilities and non-

controlling interests be calculated as though the new consolidation requirements had always applied.[1]

15 A reporting entity would not be required to adjust comparative information, but should be allowed to restate comparative information if it wishes to do so. This is consistent with the transition requirements in Statement No. 167.

Initial measurement of the subsidiary's assets, liabilities and non-controlling interests

16 We expect that most subsidiaries that would be consolidated for the first time as a consequence of the revised definition of control would currently be classified either as a joint venture or an associate. As such they will either have used proportionate consolidation (according to IFRSs) or have been accounted for using the equity method. Accordingly, we believe that the reporting entity should have the information available to determine the carrying amounts as if an acquisition had occurred when the reporting entity gained control assuming the revised consolidation requirements had always applied.

17 If the new subsidiary was previously accounted for using the equity method or proportionate consolidation, by commencing consolidation using these carrying amounts, the profit or loss attributable to the parent's ordinary shareholders would, in most cases, not be changed as a result of the change in accounting requirements. The staff believe that this is appropriate because there is no change in the economic situation at the date of first applying the revised consolidation requirements, even though the accounting requirements are changed.

18 Therefore, we recommend that when practicable (see further below) the reporting entity should measure the assets, liabilities and non-controlling interests of a previously unconsolidated subsidiary, as if the new requirements had always applied (ie as if a business combination had occurred when control was obtained in accordance with the new guidance). This is consistent with the transition

[1] When measuring the assets, liabilities and non-controlling interests the reporting entity would apply each IFRS/ASC Topic effective at the end of the current reporting period.

requirement in the Statement 167 that requires the carrying amounts to be calculated in this way on transition when practicable. This approach is also more cost efficient than applying acquisition accounting at the date of first applying the revised consolidation requirements.

19 The appendix to this agenda paper discusses in more detail some application issues associated with that approach.

Impracticability exemption

20 We acknowledge that it might not be feasible to generate the carrying amounts, as if the reporting entity had always consolidated the subsidiary, when the reporting entity has previously neither applied proportionate consolidation nor the equity method. Therefore, we recommend that the boards permit an alternative transition method if recreating the carrying amounts, as if the subsidiary had always been consolidated, should be impracticable.

21 We have identified the following alternatives as to how a reporting entity could measure the subsidiary's assets, liabilities and non-controlling interests when the method described in paragraphs 16-19 is not practicable:

(a) *Acquisition-method approach*: This approach is similar to the transition guidance proposed in ED 10 [and the approach used in the Statement 167 amendments to Topic 810-10 as the 'fall back' method]. The reporting entity applies the acquisition method in IFRS 3 and Topic 805. The date when the reporting entity applies the revised consolidation requirements for the first time is the deemed acquisition date. We acknowledge that IFRS 3 and Topic 805 contain only limited guidance on how the acquisition method should be applied when no consideration has been transferred. However, we are not aware of divergence in practice as to how the requirements should be applied. In our view, a reporting entity would measure the interest in another entity at its fair value at the date when it applies the revised consolidation requirements for the first time.

It would then recognise goodwill as the difference between (a) the fair value of the interest in the other entity and the amount of any non-controlling interest and (b) the fair values (or alternative measures required in IFRS 3 and Topic 805) of the assets and liabilities of the subsidiary. When the reporting entity applies the revised consolidation requirements for the first time, it offsets any difference between the fair value of its investment in the other entity and the carrying amount of the investment against equity (see also the appendix to this paper).

(b) *Separate financial statements approach*: This approach is similar to the requirements in IFRS 1. The reporting entity recognises the assets and liabilities of the subsidiary at their carrying amounts in the subsidiary's separate financial statements. Non-controlling interest is measured at its proportionate share of the carrying amount of the subsidiary's identifiable net assets. The goodwill would equal the difference between (i) the carrying amount of the investment in the subsidiary at the date the reporting entity adopts the revised consolidation requirements and (ii) the parent's interest in the carrying amounts of the assets and liabilities of the subsidiary.

22 In our view, both approaches have advantages and disadvantages. The transition to the revised consolidation requirements does not represent a significant economic event, but only a change in the accounting requirements. Therefore, it might not be appropriate to require a reporting entity to remeasure the assets, liabilities and non-controlling interests of the subsidiary as of that date. In addition, if the reporting entity applies the acquisition method as of the date at which it applies the revised consolidation requirements for the first time, the reporting entity might recognise (intangible) assets that it would not have recognised if it had always consolidated the subsidiary. Finally, adoption of the acquisition method approach would be costly to apply for preparers.

23 The separate financial statements approach would be cheaper to implement because it does not require the remeasurement of assets, liabilities and non-controlling interests of previously unconsolidated subsidiaries. However, under this approach:

(a) assets and liabilities of the previously unconsolidated subsidiary would be recognised at their carrying amounts, which might bear little informational value as to how much the reporting entity would have paid for the asset or liabilities in a business combination;

(b) the subsidiary might not have recognised all assets or liabilities in its separate financial statements, for example, because it might have been prohibited from recognising internally-developed intangible assets; and

(c) the separate financial statements approach does not recognise goodwill attributable to non-controlling interests.

24 We note that neither the acquisition method approach nor the separate financial statements approach will result in financial information that is fully comparable to that of a subsidiary consolidated from when control was obtained. The acquisition method approach measures the assets and liabilities at a date different from when the reporting entity obtained control of the subsidiary and applies acquisition accounting at a time when no economic change has occurred. However, some might argue that it reflects the parent being deemed to control the subsidiary for the first time on the date of first applying the new consolidation standard. The separate financial statements approach does not require the application of acquisition accounting including the determination of the fair values of identifiable assets and liabilities.

25 As both approaches do not result in comparable information, we recommend that the boards require the separate financial statements approach, which, in our view, would be consistent with the requirements for first-time adopters in IFRS 1 and easier to implement than the acquisition method approach. This would be different from the approach adopted in the Statement No. 167 and the proposals in ED10.

Deconsolidation of a previously consolidated entity

26 We believe that similar principles can be applied when the new consolidation requirements result in a reporting entity no longer consolidating an entity that was previously consolidated. The entity should be deconsolidated from the date that the new requirements are first applied. Similar considerations to those set out above arise in determining the initial carrying amount for the interests in the newly deconsolidated entity.

27 Some of those entities will subsequently be accounted for according to the equity method. We believe that the reporting entity would normally have the information available to apply the equity method as if the new requirements had always applied because it has previously consolidated the entity. The appendix of this agenda paper discusses some application issues associated with that approach.

28 Should the reporting entity neither have joint control nor significant influence over the formerly consolidated entity, we believe that the reporting entity should recognise its interest in the previously consolidated entity and measure that interest at fair value as of the date when it applies the revised consolidation requirements for the first time.

29 Consistent with our recommendations for a newly consolidated subsidiary, we recommend that comparative information is not required to be restated if a previously consolidated entity is deconsolidated. However, an entity should be allowed to elect to present comparatives if it wishes to do so. This is consistent with the transitional requirements in Statement No. 167.

Earlier application

30 We recommend that the boards allow earlier application of the revised consolidation requirements, so to prevent first-time adopters from having to apply the revised consolidation requirements, shortly after they have introduced the current consolidation requirements in IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*.

Questions for the boards

Do the boards agree with the staff recommendation that:

(1) newly consolidated subsidiaries are only consolidated and newly deconsolidated entities are only deconsolidated from the date that the new requirements are applied?
(2) a reporting entity should measure the assets, liabilities and non controlling interests of a previously unconsolidated subsidiary, as if that subsidiary had been consolidated from the date when the reporting entity obtained control of the subsidiary on the basis of the new requirements? Or alternatively, if this should be impracticable to recognise the assets and liabilities of a previously unconsolidated subsidiary at their carrying amounts in the subsidiary's separate financial statements? According to the later method the deemed cost of goodwill equals the difference at the date of transition to IFRSs between (i) the carrying amount of its investment in the subsidiary and (ii) the parent's interest in the carrying amounts of the assets and liabilities of the subsidiary?
(3) a reporting entity should measure the interest in a previously consolidated entity as if the reporting entity had accounted for that interest as if the new requirements had applied from when it was first involved with the entity or had first lost control of the entity. Or, if this should be impracticable to derecognise the assets, liabilities and non-controlling interests of the previously consolidated entity and recognise any interest in the entity at its transition date fair value?
(4) earlier application should be permitted?

Appendix – Further application issues

31 The following paragraphs discuss how a reporting entity should account on transition for:

(a) any differences between the recognised and derecognised amounts;

(b) a previously unconsolidated subsidiary that does not meet the definition of a business;

(c) the impairment of equity method investments.

Differences between the recognised and derecognised amounts

32 Differences between the recognised and derecognised amounts on transition might arise because the reporting entity measures its interest in a previously consolidated entity at fair value or because the consolidation of a previously unconsolidated subsidiary represents a bargain purchase.

33 We believe that a reporting entity should not recognise a profit or loss from its transition to the revised consolidation requirements and recommend that any difference should be offset against equity.

Consolidation of a subsidiary that is not a business

34 We agree with respondents that the initial consolidation of a subsidiary that does not meet the definition of a business would be outside the scope of IFRS 3 and Topic 805. Therefore, we recommend that the boards clarify that in those situations the reporting entity would apply the acquisition method as described in IFRS 3 and Topic 805. However, the reporting entity would not recognise any goodwill for the subsidiary. Rather, any difference between the reporting entity's interest in the subsidiary and the amount of the non-controlling interests and the assets and liabilities of the subsidiary should be offset against equity.

Equity method impairments

35 If the reporting entity consolidates a subsidiary, it does not test its investment in the equity of the subsidiary for impairment. Rather, it tests the individual consolidated assets and liabilities of the subsidiary for impairment. In contrast, IAS 28 and ASC Topic 323 require an entity to evaluate an investment that is accounted for using the equity method for impairment by comparing its carrying value to its fair value.

36 We believe that if the reporting entity consolidates a subsidiary that was previously accounted for using the equity method the reporting entity would have the information available to reverse any impairment of an investment accounted for using the equity method. However, if the reporting entity is required to apply the equity method to an entity that was consolidated before the application of the revised consolidation requirements it would be unable to estimate whether the investment was impaired at any previous reporting period, when determining the initial carrying value as though the amendments had always applied,. We believe that the reporting entity should not try to recreate past equity method investments. Rather, the reporting entity should test its equity method investment for impairment as of the date when it applies the revised consolidation requirements for the first time.