Preparation of separate financial statements when the entity is exempted from issuing consolidated Financial Statements

Title and objective of IAS 27, Separate Financial Statements

Shall the name of the standard be **modified?**

Benefit

- **Focus on relief** to subsidiaries from preparing IFRS accounts
  - Example of new name for IAS 27: 'FS's of subsidiaries'

Disadvantage

- Current version of IAS 27 does not relate only to subsidiaries
  - Alternative approach: add a separate section in IAS 27 to focus on simplified rules for subsidiaries when certain conditions are met

Clarify the objective of separate financial statements (SFS's)

› to provide a more robust basis when difficulties of application of IFRS to separate financial statements arise in practice

› where do SFS's fit in the Conceptual Framework? Could they be subject to different conceptual principles than the full IFRS financial statements?

› where should/may SFS's be a continuation of the parent's consolidated financial statements (representing a separate component and using the same basis of accounting and measurement as the parent uses) and where should/may they represent independent financial statements? Which users should the purpose depend on (only or combination of the parent, other shareholders, regulators, tax authorities, other interested parties)?

Push-down accounting

Shall subsidiaries be allowed to use "pushdown accounting"?

Benefits

- Allowing the election to use "pushdown accounting" or the "stepped-up basis" of the acquirer for the assets and liabilities of the acquired company would allow to avoid separate tracking of assets, such as goodwill and fixed assets, at two different values (historical and "stepped-up basis") and simplify preparation of consolidated financial statement of the acquirer

Disadvantages

- Allowing the election will lead to using different basis in different cases: pushdown accounting typically results in higher net assets for the acquired company on the acquisition date. This in turn usually results in lower net income in periods subsequent to the acquisition due to higher amortization, higher depreciation, and potential impairment charges
- Companies may prefer to carry over their historical basis for financial reporting purposes when carry over basis is being used for tax reporting purposes (that is, when there is no tax "step-up")
- The use of "pushdown accounting" could result in revaluation of assets and liabilities which would contradict with some IFRS requirements (for example consistent application of cost model for fixed assets measurement). There could be a lack of economic substance in situation where a subsidiary revalues its assets and liabilities every time when it is acquired by another company. The new guidance should contain clarification when use of "pushdown accounting" would be appropriate (refer to speaker notes for this slide)

Intercompany transactions

Shall gains or losses on intercompany transactions be recognized in **equity?**

Benefits

- **Focus on substance** of transactions with the parent as **owners of the subsidiary**
- Intercompany gain/loss within the Group may be viewed as having **no commercial substance**

Disadvantages

- In situations where the transaction has normal commercial substance (from the single legal entity perspective) - recognition of gains or losses in equity for such transactions could distort real economic story of the entity. Development of the guidance for different approaches for different types of transactions could be a complex task
- If the subsidiary is not 100% owned - part of intercompany profit and loss may relate to NCI

Presentation of NCI separately from the controlling party interest

Accounting for non-controlling interest (NCI), which represents the equity (or net assets) of subsidiary that is not attributable to the parent and its other subsidiaries.

- Should separate FS reflect NCI?
- Should NCI be determined as a proportionate share of the subsidiary's net assets?

Benefits:

- Presentation of the share of net assets of a subsidiary that relates to controlling and non-controlling parties will help to distinguish between different groups of shareholders in the equity of the company and indicate the potential distribution of the company's equity

Disadvantages:

- The financial statements reflect the NCI from the perspective of the controlling party but a subsidiary is a separate economic entity and its equity belongs to all shareholders
- This NCI could not be equal to NCI from the parent's financial statements (parent's NCI could be measured at fair value or as proportionate share of the subsidiary's net identifiable assets based on PPA – purchase price allocation - as part of IFRS 3 accounting)
- Complex accounting of NCI (transactions between shareholders, indirect holding, situations when parent owns less than 50% but has control)

Accounting for shared resources paid by the parent or another entity of the group

Allocation of expenses incurred at the parent level

- Should separate FS reflect a reasonable allocation of expenses from the parent?
- Ex: payroll accounting, pensions, centralised purchasing, marketing, executive management, rent, advertising.....

Benefits:

- Separate FS should reflect all economic activity arising from the business of the subsidiary (no matter where they are paid from)

Disadvantages

- This proposal is applicable only if Parent does not re-invoice the subsidiary
- Determining the basis for allocation and measurement might be complex/arbitrary eg the parent re-invoice may be at cost, with reasonable profit margin or other
- Additional effort for the companies

Business acquisition under common control

Business combination under common control for separate financial statements

- Definition of BCUCC and method of accounting is part of a priority Research project of the IASB

IFRS 11 – Joint operations

Should there be an exemption from applying IFRS 11 rules for joint operations with the parent or its subsidiaries where the joint operation is a separate legal entity?

Current approach based on IFRS 11:

- In its separate financial statements a joint operator shall account for its share in joint assets, liabilities, revenue, expenses. When an entity acquires an interest in a joint operation in which the activity of the joint operation constitute a business, it shall apply principles of IFRS 3 and other IFRSs that do not conflict with IFRS 11 guidance

Should the current requirement change and should joint operator be allowed to account for its interest in a joint operation in accordance with p.10 of IAS 27 Separate financial statements?

Benefits:

- Exemption from applying IFRS 11 in separate FS would significantly simplify the accounting as there would not be need to account for share in joint assets, liabilities, revenue, expenses and apply principles of IFRS 3 and other IFRSs on acquisition

Disadvantages:

- This would not be in line with the principles of IFRS 11 to reflect the rights of a joint operator to the assets and obligation for the liabilities, relating to the arrangement

Financial instruments (1/2) – simplification of accounting for subsidiaries

For loans from/to the parent should there be an exception from initial recognition at fair value?

- Such loans are often provided at lower interest rates or interest-free and their recognition at fair value results in recognising capital contributions (loans received) or distributions in equity. There are also deferred tax consequences
- If such loans are exempted – they will be recognised at nominal amount

Should there be an exception for inter-company guarantees (eg a number of subsidiaries guarantee debt of the parent to the banks) from recognising them initially at fair value?

- Such guarantees are often provided at no fee and the subsidiaries have to estimate the initial fair value for accounting purposes. The estimated fair value is often subjective
- If such guarantees are exempted, they will be measured in accordance with IAS 37 only when a payment under the guarantee becomes probable

Financial instruments (2/2) – simplification of accounting for subsidiaries

Should there be an exemption from applying IFRIC 4 which extends the definition of a lease contract to intra-group leases?

- Application of the extended definition of a lease in IFRIC 4 to intra-group leases at a subsidiary level results in many complexities
- This is likely to be a temporary exemption, if provided, because IFRS 16 introduces a broader definition of a lease and brings nearly all leases on lessees balance sheets

Should there be an exception for embedded derivatives in contracts with sister companies to deliver non-financial items (eg commodities)?

- Such derivatives currently have to be assessed for separate accounting at fair value throughout the period of the respective contract. If separation is required, fair value of derivatives has to be determined at each reporting date

Other relief

Should there be simplified tax accounting for companies that are part of a consolidated tax group (exemption from IAS 12)?

Benefit

- Exemption from recording taxes in a separate FS would significantly simplify the accounting as there would not be need to make complex allocations of the consolidated tax to separate tax group entities

Disadvantage

- This would not reflect a real economic result of activity of the subsidiary

Capitalisation rate

Should subsidiaries be allowed to use the capitalisation rate that is used for Group purposes?

Benefits

- Including all borrowings of a parent and its subsidiaries into one pool and using a Group capitalisation rate is more appropriate and reflects the substance, where: the treasury function is managed centrally within the Group, or the parent and the subsidiaries are all within the same geographical area and their borrowings are generally on similar terms, and there are no significant restrictions on the transfer of funds among the entities in the group
- This would allow to avoid double of artificial accounting for borrowing costs differently at the level of Subsidiary and the consolidated level

Disadvantage

- This may not reflect the real economic result of the activity of the subsidiary as a single legal entity

Disclosures requirements

Should there be an exemption from disclosure of certain information (for example, IFRS 7 disclosures) by subsidiaries that are part of the larger group?

Benefit

- Exemption from certain disclosures in separate FS would significantly simplify preparation of financial statements

Disadvantage

- This would result in lack of information that is useful for certain users (for example, finance organisations)

IFRS for SMEs

Should IFRS for SMEs (rather than full IFRS) be allowed to be applied by subsidiaries that are part of a larger group irrespective of the size of the subsidiary?

Benefit

- Exemption from applying full IFRS in separate FS would significantly simplify preparation of financial statements (would enable simplifications in some complex accounting areas and also reduce the disclosure requirements)

Disadvantages

- This would result in lack of information that is useful for certain users (for example, finance organisations)
- When there are significant differences in approach between IFRS for SMEs and full IFRS this could potentially result in more complicated task and the need to monitor the differences