Preparation of financial statements of subsidiaries

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Issue 1: Objective of IAS 27, Separate Financial Statements

Current requirements and issues

- A subsidiary is not required to present consolidated financial statements if it meets certain conditions [IFRS 10.4]. There may be situations where separate financial statements are the only set of financial statements presented by a company.
- Entities that do not have public accountability may prepare simplified financial statements under *IFRS for SMEs* [para 1.2 IFRS for SMEs].
- A subsidiary that does not have public accountability and whose parent uses full IFRS, is not prohibited from using IFRS for SMEs in its own financial statements.
- But in that case they must comply with all of the provisions of IFRS for SMEs.
- The focus of IFRS (including of disclosure requirements) is generally on consolidated financial statements and they are often complicated to apply for preparation of separate financial statements.

Issue 1: Objective of IAS 27, Separate Financial Statements

Current requirements and issues

- Subsidiaries (intermediate parents) are not permitted to use the simplified disclosures provided by the IFRS for SMEs and at the same time to follow the accounting recognition and measurement principles in full IFRS.
- If they are different from the accounting recognition and measurement principles in the IFRS for SMEs.
  - should IFRS disclosure requirements be amended to deal with disclosures within the context of separate financial statements?
  - should there be symmetry in the accounting for transactions or events in separate and consolidated financial statements?

Issue 1: Objective of IAS 27, Separate Financial Statements

Suggestions

- To give entities more flexibility in choosing a combination of accounting policies aligned with consolidated group accounting policy, and at the same time to use the disclosure simplifications provided to small and medium-sized entities by IFRS for SMEs (where certain criteria are met).
- To consider amending the title of the standard for transparency (for example, "Simplified Financial Statements for Separate Entities").

Issue 2: Application of IFRS 1 where a subsidiary becomes a first-time adopter of IFRS later than its parent

Current requirements and issue

- If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall, in its financial statements, measure its assets and liabilities at either:
  (a) the carrying amounts that would be included in the parent's consolidated financial statements, based on parent's date of transition to IFRS, (taking into account that the parent has not made any adjustments for consolidation procedures and for the effects of the subsidiary's business combination; or
  (b) the carrying amounts required by the rest of IFRS 1, based on the subsidiary's date of transition to IFRS.
  [Appendix D16, IFRS 1]
- Should the exemption apply to all subsidiaries, including those which were not part of the consolidated group at the transition date of the parent? In other words, should the subsidiary be allowed to use this exemption if it was acquired after the transition date of the parent?

Issue 2: Application of IFRS 1 where a subsidiary becomes a first-time adopter of IFRS later than its parent

Suggestions

- To consider amending the current wording of the standard to explicitly allow this exemption when the subsidiary was not part of the consolidated group at the transition date of the parent.

Issue 3: Pushdown accounting in separate financial statements

Current requirements and issue

- Under IFRS 3, an acquirer of a business initially recognises most of the acquired assets and liabilities at fair value and recognises goodwill. These numbers are not pushed down to the financial statements of the acquiree under IFRS.
- IFRS does not states clearly whether pushdown accounting is acceptable in the separate financial statements of an acquired subsidiary.
  - View 1 – it is not acceptable, because this would result in the recognition and measurement of assets and liabilities in a manner that conflicts with certain IFRS standards and interpretations
  - View 2 - it is acceptable for some situations in which transactions such as capital reorganisations, common control transactions, etc., may result in an accounting outcome that is similar to pushdown accounting.
- Should the acquired subsidiary keep the accounting of the same assets and liabilities using a different basis, depending in which financial statements these values are to be presented?

Issue 3: Pushdown accounting in separate financial statements

Suggestions

- To allow using of pushdown accounting in separate financial statements of acquire which will provide better control over integrity of similar data and simplification for the preparers, regulators and auditors as one set of data is used.
- To consider the changing of control over a company as a significant economic event to the acquired entity, that could be a valid reason for re-measuring an entity's net assets in separate financial statements in order to provide a more faithful depiction of the transaction in certain circumstances.

Issue 3: Pushdown accounting in separate financial statements

Intercompany sales of goods between subsidiaries of a group

- The entities that are part of a larger group may sell goods to each other. For example, when subsidiary A purchases goods for 100 and sells them to subsidiary B for 150, goods are recorded at 150 in the subsidiary's financial statements and at 100 in the group reporting forms and at the group level.
- Therefore, it could be considered to record the goods at the subsidiary level also at 100, with the difference recorded in capital to avoid two measurement bases. As a result, the group reporting forms would reflect goods at 100, whereas separate financial statements of subsidiary would reflect goods at 150.

Issue 4a: Intercompany loans at non-market rates

Current requirements and issue

- Loans should be recognised at fair value at the initial recognition, applying market rates
- The effect should go to equity or statement of comprehensive income depending on the economic substance of transaction
- The lender’s and borrower’s accounting should mirror each other
- Loans and related interest are eliminated upon consolidation, while it requires significant effort to estimate the market level of rates and calculate the adjustment

Suggestions

- To recognise the loans at contractual rates, even if they are zero

Issue 4b: Intercompany guarantees at non-market rates

Current requirements and issue

- Guarantees issued should be recognised at fair value at the initial recognition
- The accounting for the debtor is not described
- Subsequently guarantees issued are accounted for at the higher of the amount of unearned commission or amount estimated in accordance with IAS 37/IFRS 9
- Loans and related interest are eliminated upon consolidation, while it requires significant effort to estimate the market level of rates and calculate the adjustment

Suggestions

- To recognise the in accordance with the contractual terms, even if the commission is zero

Issue 5: Measurement of assets and liabilities in subsidiary's financial statements: fair value versus cost

Current requirements and issue

- IAS 27 permits entities to measure investments in subsidiaries either: at cost, in accordance with IFRS 9, or using the equity method under IAS 28.
- In separate financial statements other assets and liabilities should be measured and accounted for in accordance with the relevant IFRS.
- A growing number of standards require fair value measurement: IFRS 2, 5, 9, 15, IAS 41, therefore fair value measurement requires the use of judgment and significant efforts, which will result in that costs on fair value measurement exceed the benefits from provided financial information.

Issue 5: Measurement of assets and liabilities in subsidiary's financial statements: fair value versus cost

Suggestions

- To simplify of the measurement of certain assets and liabilities in separate financial statements.
- Questions to be addressed:
- 1) Should the historical cost basis be optional as an accounting policy or required in separate financial statements?
- 2) If it will be an option, then the following questions arise:
  - a. Should the option of choosing an accounting policy be allowed for all the mentioned assets and liabilities accounted for under IFRSs, or only for some of them?
  - b. Should the option of choosing an accounting policy be allowed for all entities, or only for some of them, or only in certain circumstances?
  - c. Should entities be obliged to disclose the fair value measurement for some assets and liabilities, even if they use the cost basis?
  - d. Should the option of choosing an accounting policy be available depending on the presentation of consolidated financial statements?
  - e. Should the choice of accounting policy for assets and liabilities be made on a class by class basis or at the level of the entity?

Issue 5: Measurement of assets and liabilities in subsidiary's financial statements: fair value versus cost

Considerations related to accounting in separate financial statements of internally generated intangible assets and contingent liabilities at fair value

- IAS 37 and IAS 38.63 prohibits recognition of a contingent liabilities and internally generated brands, mastheads, publishing titles, customer lists and items similar in substance.
- We suggest to consider whether to establish an accounting policy choice for recognition these assets and liabilities at fair value if the separate financial statements are prepared for M&A transactions or business valuations.

Issue 6: Measurement basis for financial assets received in a reorganisation

Current requirements and issues

- Preparers need to apply common requirements, since IFRS 9 does not contain specific measurement guidance for these financial assets
- From the perspective of the subsidiary, this is initial recognition. Therefore, these assets initially are recognised at fair value, plus transaction costs [IFRS 9.5.1.1]
- Based on the principle of "substance over form", the cost of received financial assets should be determined on the basis of the predecessor value basis.

Suggestions

- To develop a guidance on measurement (for example, predecessor value basis) of financial assets received by a subsidiary in a reorganisation.
- The following questions must be addressed:
  - Should a company be allowed to initially recognise financial assets received in a reorganisation at the predecessor value basis? If yes, should this be optional or mandatory? If optional, should the choice of accounting policy be made on an instrument by instrument (transaction by transaction) basis or at the level of the entity?

Issue 7: An exemption from applying IFRS 11 rules for joint operations where the joint operation is a separate legal entity

Current requirements

- Joint arrangements that are run in a separate legal entity may be classified either as a joint operation or a joint venture.
- In relation to its interest in a joint operation, a joint operator should recognise: share of any assets held jointly, share of any liabilities incurred jointly, share of revenue and share of expenses in both consolidated and separate financial statements of the joint operator.
- The accounting for the joint operation may be complex, especially when the investors have different rights to particular assets and liabilities of the joint operation and when there are transactions between a joint operation and the investors that need to be eliminated wholly or partially.
- The accounting for a joint operation that is a separate legal entity adds significant complexity to the preparation of separate financial statements and is more burdensome than the accounting for investments that are controlled by an investor instead of jointly controlled.

Issue 7: An exemption from applying IFRS 11 rules for joint operations where the joint operation is a separate legal entity

Suggestions

- Should the recognition of different types of investments held by a legal entity (i.e. investments in subsidiaries, joint arrangements, associates) be governed by similar rules in the separate financial statements of an investor?
- Should the investor be allowed to account for its interest in a joint operation that is a separate legal entity in accordance with para 10 of IAS 27 (consistently with investments in subsidiaries where legal boundaries matter).

Issue 8: Simplified tax accounting for companies that are part of a consolidated tax group (exemption form IAS 12)

Current requirements and issues

- IFRS does not contain specific guidance for income tax accounting for consolidated tax groups (CTG).
- As IFRS does not contain specific rules, there may be options.
- The mechanisms for the calculation and allocation of the income tax among CTG participants may be complex and might depend on the tax rules in a particular jurisdiction.
- However, under each option and/or jurisdiction, each CTG participant would have to provide for income tax in its separate financial statements and, therefore, it would have to make substantial efforts to calculate it.

Suggestions

- To exempt the entities from recording income taxes in their separate financial statements, if the entity is a part of CTG.

Issue 9: Simplifications in respect of capitalisation of borrowing cost in a subsidiary's financial statements

Current requirements and issue

- IAS 23 requires to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.
- To capitalise borrowing costs from generally borrowed funds, an entity should determine the capitalisation rate, being the weighted average interest rate of the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.
- Calculation of the amount of borrowing cost to be capitalised is a very complex exercise, particularly for general borrowings due to changes in the borrowings during the year; and changes in the construction in progress.
- In a group situation, the amount of capitalisable borrowing cost may be different at subsidiary and group level, thus need for complex eliminations for consolidation purposes arises.

Issue 9: Simplifications in respect of capitalisation of borrowing cost in a subsidiary's financial statements

Suggestions

- To restore the accounting policy choice between capitalising and expensing the borrowing cost in separate financial statements.
- To introduce different accounting policies in a subsidiary's financial statements for the funds specifically borrowed for the construction of an asset, and for general borrowings. The general rules of IAS 23 would apply to specific borrowings, mandating the capitalisation. For general borrowing costs, there could be either an accounting policy choice between expensing and capitalisation, or the capitalisation would be prohibited.
- To allow subsidiaries in their financial statements to use the capitalisation rate that is used by their parent in preparing consolidated financial statements.

Issue 10: Allocation of expenses from the parent (payroll, pensions, rent, etc.) when such expenses are not re-invoiced

Current requirements and issue

- There is no general requirement in IFRS to allocate the expenses incurred at the parent level (such as pension, payroll, rent, centralised purchasing, executive management and advertising, etc.) when they are not re-invoiced.
- The question may arise as to whether the separate financial statements of the subsidiaries should reflect a reasonable allocation of the above expenses.
- IFRS 2 "Share-based Payments" contains relevant guidance for group share-based payment arrangements, but, as mentioned above, there is no similar requirement for the other expenses incurred at the parent level.

Suggestions

- Following the logic in IFRS 2, in the subsidiaries' accounts, a portion of expenses incurred at the parent level could be recognised in income statement and a credit would be recognised in equity.
- The credit to equity would be treated as a capital contribution (the parent is compensating the subsidiaries' expenses with no recharge).

Issue 10: Allocation of expenses from the parent (payroll, pensions, rent, etc.) when such expenses are not re-invoiced

Disclosure of information about transactions between subsidiaries of a group

- The intercompany gains and losses are eliminated in the consolidated financial statements of the parent. Therefore, this information is not visible to the users of the consolidated financial statements, in particular to the non-controlling shareholders of the subsidiaries.
- In cases when transaction are concluded at below or above the market, the non-controlling shareholders would not be aware of the information about under or over profit/losses, but it might be useful for them. Therefore, it would be beneficial to disclose it as part of related party disclosures.

Conclusion

For every issue and the whole project we have to consider carefully at least the following:

- Would amendments meet the expectation of primary users of financial statements?

- Whether we will consider this issues separately or it will be in the scope of one project?

- Is it worth to consider these issues with those that have been highlighted by Severinus Wijaya on last EEG meeting held December 2017 under the scope of the topic “Accounting for micro entities”?