Agenda Paper 5

Emerging Economies Group Meeting

ACCOUNTING FOR SUBSIDIAIRY ENTITIES

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Financial Statement Reporting by Subsidiary Entities - intro

The purpose of this paper is to discuss practical issues related to the preparation of financial statements by entities that are part of a larger group of entities. The paper investigates the typical challenges faced by preparers and users of financial statements.

The issues presented in this paper include issues in the preparation of separate financial statements as such and matters related to cases when combination of entities takes place, including where entities that transition to IFRS later than their parent companies and pushdown accounting.

Recent changes in the tax legislation of some emerging market countries, where separate financial statements are becoming the basis for tax charges, have added to the need to reconsider some of the current requirements of IAS 27. We believe that the difficulties for preparers and users identified in this paper may also contribute to the agenda of the IASB's *SMEs that are Subsidiaries* research pipeline project.

In May 2016, in response to feedback from the 2015 Agenda Consultation, the IASB included a project on subsidiary SMEs in the research pipeline. We think that resolving the issues highlighted in this paper at the level of IFRS would help to establish the feasibility of permitting SMEs to use the recognition and measurement requirements in IFRS and the disclosure requirements in the IFRS for SMEs.

The Next Agenda Consultation is expected to start around 2021. In our view, some of the issued discussed in this paper need to be resolved earlier.

Each situation is unique, but there are several common themes. In this paper, we do not aim to cover all possible scenarios, but rather to highlight those areas of most urgent need or where quick fixes would be possible in our view. Our purpose is primarily to bring up practical issues for discussion and we are aware that we have not covered all matters.

This paper includes where applicable different views or ways of looking at a specific concern identified by those who prepare and use separate financial statements under IFRS. We acknowledge that there are no ideal approaches, and that accounting will, on every occasion, depend on the facts and circumstances of each transaction as well as on how the transaction impacts the decisions of users. At the same time, if a solution is transparent, reduces (or does not increase) the information gap between the providers of capital and the entity, and contributes to the efficient utilisation of the entity's resources, it is worthwhile to consider for a standard setting process.

Issue 1: Objective of IAS 27, Separate Financial Statements

Current requirements

Separate financial statements are presented in addition to consolidated financial statements and to the financial statements of an investor that does not have investments in subsidiaries but has investments in associates or joint ventures accounted for using the equity method [IAS 27.6]. There may be situations where separate financial statements are the only set of financial statements presented by a company. A subsidiary is not required to present consolidated financial statements if it meets all the following conditions [IFRS 10.4]:

(i) it is a wholly- or partially-owned subsidiary of another entity and all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(ii) its debt or equity instruments are not traded in a public market;

(iii) it has not filed, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market;

(iv) its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRS.

Thus, a subsidiary may prepare simplified financial statements if its parent company presents consolidated financial statements with information about investments in all its subsidiaries. The simplification applies only to the accounting of investments in subsidiaries, associates and joint ventures in the separate financial statement, which may be accounted for at cost, in accordance with IFRS 9, or using the equity method [IAS 27.10].

The IASB issued IFRS for SMEs in 2009 with the intention of simplifying the preparation of financial statements by SMEs. As stated in the standard, IFRS for SMEs may be applied by an entity that does not have public accountability [para.1.2], according to the following criteria:

(1) its debt or equity instruments are not traded in a public market and the entity is not in the process of issuing such instruments for trading in a public market; or

(2) it does not hold assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses (most banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks).

A subsidiary that does not have public accountability and whose parent uses full IFRS, or that is part of a consolidated group that uses full IFRS, is not prohibited from using IFRS for SMEs in its own financial statements. Para 1.6 of IFRS for SMEs states that if an entity's financial statements are described as conforming to IFRS for SMEs, they must comply with all of the provisions of IFRS for SMEs. Some of the differences between IFRS and IFRS for SMEs can be eliminated by accounting policies (for example, recognition and measurement of financial instruments [IFRS for SMEs, para.11.2]), but some cannot be addressed due to a lack of options (for example, in accordance with IFRS for SMEs, section 25, all borrowing costs should be expensed, whereas IAS 23 requires their capitalisation under certain conditions [IAS 23.8]).

The issue

The presentation of separate financial statements is not mandatory under IFRS. In some countries, listed companies are required by law to present separate financial statements. Some entities prepare separate financial statements voluntarily. For example, in some circumstances, an intermediate parent may elect not to prepare consolidated financial statements and instead prepare only separate financial statements.

Regardless of the purpose that a single entity (such as a parent or investor) may choose for preparing financial statements, these statements should provide relevant, decision-useful information to users. Financial statements of subsidiaries often serve a critical role in complying with legal requirements in numerous jurisdictions, for instance, forming a tax base or determining indicators of insolvency or bankruptcy.

For those applying IFRS to financial statements presented by an intermediate parent or an investor (or subsidiaries' financial statements), there are practical concerns about the relevance, existence and clarity of some IFRS requirements to such financial statements. The focus of IFRS is generally on group's consolidated financial statements and they are often silent, ambiguous, vague and hence complicated to apply when it comes to dealing with certain accounting issues in subsidiaries' financial statements. Similarly, as disclosure requirements in IFRS are often focused on groups' consolidated financial statements, there are questions about whether IFRS requirements need to be amended to properly deal with disclosures within the context of subsidiairies' financial statements. Questions have also been raised about whether there should be symmetry in the accounting for transactions or events in subsidiaries and the parent group consolidated financial statements. It is also worth noting that the IFRS Interpretations Committee has received many questions about the current IFRS, where guidance on subsidiaries financial statements is, as indicated above, lacking or unclear. For example, transaction costs for non-controlling interests (July 2009), group reorganisations in separate financial statements (September 2011), accounting by the joint operator in its separate financial statements (March 2015).

Subsidiaries (intermediate parents) are not permitted to use the simplified disclosures required by the IFRS for SMEs and at the same time to follow the accounting recognition and measurement principles in full IFRS that are used in their ultimate parent consolidated accounts if they are different from the accounting recognition and measurement principles in the IFRS for SMEs. As a result, two set of principles might give rise to differences between the accounting policies of a consolidated group using full IFRS and its subsidiaries using IFRS for SMEs.

Suggestions

As indicated above, subsidiaries (and even parent companies) often produce legal entity financial statements only for compliance and tax purposes. In such situations, there are arguments for providing entities with more flexibility in choosing a combination of accounting policies aligned with consolidated group accounting policy, where it makes sense, and at the same time to use the disclosure simplifications provided to small and medium-sized entities by IFRS for SMEs.

As stated earlier, IAS 27 provides only one simplification (regarding investments in other companies). In all other respects, a subsidiary financial statements should comply with full IFRS. In light of the discussion above, we suggest that IAS 27 (or any equivalent standard) be just a standard for entities where a subsidiary financial statements are needed primarily for compliance or other than for provision of information to non-controlling investors (lenders). The application of these simplifications should be voluntarily (provided specific criteria are met). Simplifications allowed for subsidiaries in the circumstances described above should render relief so that the cost of preparing information for is balanced with the benefits to the users of those statements.

We understand that it is impossible to establish rules that will fit all entities with different businesses. Therefore, we suggest that only certain entities in certain circumstances be allowed to apply simplifications in their financial statements, in particular, intermediate subsidiaries that are exempted from presenting consolidated financial statements or that present legal entity financial statements in addition to consolidated financial statements, because of compliance requirements, or for purposes other than the provision of information to non-controlling investors (lenders).

The title of the standard for simplified financial statements prepared in the circumstances described above may also be made transparent in accordance with the purpose (for example, it could be "Simplified Unconsolidated Financial Statements").

Advantages and disadvantages

Advantages:

1) *Cost-benefit balance.* It was already noted that full IFRS requirements can give rise to difficulties in preparing financial statements by subsidiaries, as well as extra costs. In some cases, these costs may be unjustified. Simplifying and clarifying the requirements would address this problem.
2) *Comprehensibility.* Information presented in simplified financial statements would be easy for users to understand and analyse.
3) *Flexibility.* Simplifying the requirements, as well as the options and rights to establish accounting policy, would improve transparency and fair presentation of events in financial statements of subsidiaries. This would fit the purpose of presented statements in the best way.

Disadvantage:

1) *Comparability.* More options would give rise to the different presentation of similar transactions. One of the bases for choosing an accounting policy would be whether it simplifies financial statements. The same entity could apply different options in different sets of financial statements, which would deteriorate the comparability. Comparability of financial information of different legal entities would also be deteriorated.

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

Current requirements

Appendix D of IFRS 1 provides subsidiaries that are first-time adopters of IFRS later than their parents with an exemption related to measuring their assets and liabilities. Specifically, paragraph D16 of IFRS 1 explains that:

> "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 the parent's date of transition to IFRS, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary (this option is not available to subsidiaries of investment entities, as defined in IFRS 10, that are required to be measured at fair value through profit or loss); or
>
> (b) the carrying amounts required by the rest of this IFRS, based on the subsidiary's date of transition to IFRS."

Currently, practical issues may arise when a subsidiary (adopting IFRS later than its parent) plans to use the values from the parent's consolidated financial statements.

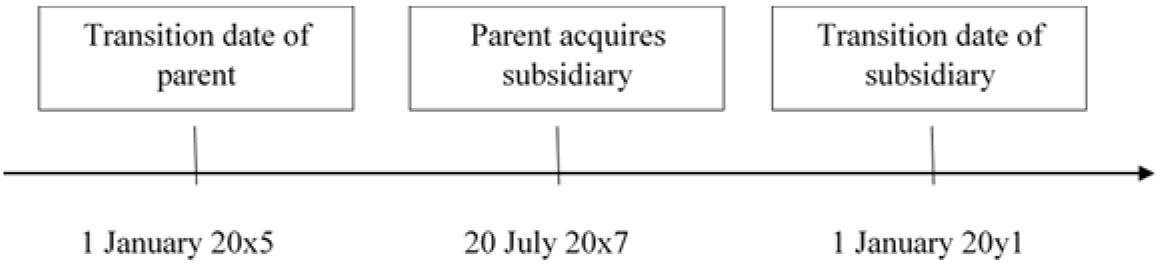
The issue

Should the exemption to carry parent's consolidates group values apply to all subsidiaries, including those which were not part of the consolidated group at the transition date of the parent and those which are included into consolidated financial statements at parent's transition date in amounts established as a result of business combination accounting?

Example for situation when subsidiary was not part of the group on the parent's transition date.

The parent and its group transitioned to IFRS on 1 January 20x5. The parent acquired 100% of a subsidiary on 20 July 20x7 and on consolidation recognised the assets and liabilities of the subsidiary at fair value, as required by IFRS 3. The subsidiary continued to apply its local GAAP and its accounting policy was to account for PPE at cost.

In 20y2, local regulations required the subsidiary to adopt IFRS with a transition date of 1 January 20y1.



As part of the transition exercise, the subsidiary wishes to carry its assets and liabilities at the same values shown in the group consolidation. It means, specifically with regard to PPE, that the subsidiary intends to use its PPE fair value, determined as part of acquisition accounting under IFRS 3.

Question based on the scenario: since the parent calculated the PPE fair value on the acquisition, can the subsidiary use this fair value on the transition to IFRS?

Based on Appendix D para 16, it is clear that the measurement date has to be either (a) the parent's transition date or (b) the subsidiary's transition date. As the subsidiary was acquired after the parent's date of transition to IFRS, option (a) is not available here. The subsidiary was not included in the parent's consolidated financial statements at 1 January 20x5 and, therefore, such carrying amounts simply do not exist. Accordingly, the subsidiary has to measure the carrying amount (fair value as deemed cost) based on its own transition date.

Based on current practice of applying the IFRS requirements which we observe, the subsidiary will not be able to record its PPE at the same values carried in the group consolidation.

Nevertheless, this guidance may need to be more flexible. Appendix D para 16 (a) allows the carrying amount to be measured in amounts that would be included based on the parent's date of transition but does not require the fair value to be determined as at that date. The subsidiary may be allowed to use the fair values calculated by the parent on the acquisition date. The carrying values would be based on the fair value as at 20 July 20x7 and adjusted for the applicable depreciation between 20 July 20x7 and 1 January 20y1.

By allowing this choice, the subsidiary does not have to re-measure the fair value at 1 January 20y1, and in the subsidiary's financial statements, the IFRS book value of the PPE would be the same as for the group consolidation.

Suggestions

We suggest to consider amending the standard to allow this exemption when the subsidiary was not part of the consolidated group at the transition date of the parent or when it was accounted by parent at amounts established as a result of business combination accounting at the parent's transition date. This amendment would simplify measurement requirements, increase consistency between group's ultimate parent consolidated and subsidiariesfinancial statements, ease the transition to IFRS and save costs for entities.

Issue 3: Pushdown accounting in a subsidiary's financial statements

The issue

Under IFRS 3 *Business Combinations*, an acquirer of a business initially recognises most of the acquired assets and liabilities at fair value. The controlling party would have applied the acquisition method, and it would have recognised assets and liabilities (including goodwill) in accordance with IFRS 3. These numbers are not pushed down to the financial statements of the acquiree under IFRS. The subsidiary then has to keep the accounting of the same assets and liabilities using a different basis, depending in which financial statements these values are to be presented. When there is more than one level of consolidation in the group, the subsidiary may be required to account for its assets and liabilities on a historical basis for its financial statements, and prepare more than one set of accounts under the new basis using the stepped-up basis for each level of consolidation. Maintaining more than one set of financial information under different bases of accounting results in an additional burden to the acquired entity. Furthermore, it is difficult for the internal and external users of the financial information to assess the reasonableness of using the different bases of accounting for the same assets and liabilities.

Current requirements

If pushdown accounting were acceptable under IFRS, in the financial statements of the acquired business, the stepped-up basis of the acquirer could be reflected. Pushdown accounting establishes a new basis for the assets and liabilities of the acquired company based on a pushdown of the acquirer's stepped-up basis. IFRS does not address pushdown accounting. However, it is optional under some other financial reporting frameworks, such as US GAAP.

As mentioned, no IFRS guidance exists, and it is unclear whether pushdown accounting is acceptable under IFRS. The general view is that entities may not use the hierarchy in IAS 8 to refer to US GAAP and apply pushdown accounting in the financial statements of an acquired subsidiary, because this would result in the recognition and measurement of assets and liabilities in a manner that conflicts with certain IFRS standards and interpretations. For example, the application of pushdown accounting generally results in the recognition of internally generated goodwill and other internally generated intangible assets at the subsidiary level, which conflicts with the guidance in IAS 38.

Nevertheless, there are situations in which transactions such as capital reorganisations, common control transactions, etc., may result in an accounting outcome that is similar to pushdown accounting, where the new basis of accounting established by the parent, including goodwill and purchase price adjustments, is reflected in the acquired company's financial statements.

This raises the following questions:

- Could pushdown accounting be permitted in a subsidiary's financial statements under IFRS?
- If yes, then:
    - Would the application of pushdown accounting be optional or mandatory?
    - Would the scope apply to all subsidiaries or only those selected under certain criteria (substantial ownership, listed businesses)?
    - Would the permitted accounting be applied retrospectively or prospectively?

- ***Example of pushdown accounting***
- Assume that Company P acquires, in an open market arm's-length transaction, 90% of the common stock of Company S for 465 million currency units. At that time, the net book value of Company S was 274 million (for the entire company). The book and fair values of identifiable assets and liabilities of Company S as of the transaction date are summarised in table below. The example ignores the tax effects of the transaction. Since the step-ups in carrying value would not, in all likelihood, alter the corresponding tax bases of the assets and liabilities, the deferred income tax effects would also require recognition.

	Book value		Fair value of 90% interest	Excess of fair value over book value
	100% of entity	90% interest		
Assets				
Property, plant and equipment	434	390.6	488	97.4

Additional goodwill			120.3	120.3
Other non-current assets	223	200.7	200.7	0
Inventories	22	19.8	25	5.2
Receivables	25	22.5	30	7.5
Total assets	*704*	*633.6*	*864*	*230.4*
Equity				
Share capital	87	78.3	78.3	0
Retained earnings	187	168.3	168.3	0
Revaluation surplus*			218.4	218.4
Total equity	*274*	*246.6*	*465*	*218.4*
Liabilities				
Bonds payable	105	94.5	89	(5.5)
Other payables	325	292.5	310	17.5
Total liabilities	*430*	*387*	*399*	*12*

** Net premium paid over book value by arm's-length of "almost all" common stock*

Assuming that the new basis accounting is deemed to be acceptable and meaningful, since Company S must continue to issue financial statements to its creditors and the tax authorities, and that the share of ownership of non-controlling interest (10% in this example) should not be revalued based on the majority transaction, the entries by the subsidiary (Company S) in its financial statements would be as follows:

Property, plant and equipment	97.4
Goodwill	120.3
Inventories	5.2
Receivables	7.5
Discount on bonds payable	5.5
Other payables	17.5
Revaluation surplus in equity	218.4

If the consolidated financial statements of Company P are also presented, essentially the same result would be obtained. The additional paid-in-capital account would be eliminated against the parent's investment account.

As illustrated in this example, goodwill will be calculated and recognised by the acquired company consistent with the business combination accounting. However, when applying pushdown accounting, bargain purchase gains should not be recognised in the income statement of the acquired company. Instead, an adjustment in additional paid-in-capital within equity should be recognised.

Typical impact in pushdown accounting

The typical impact of pushdown accounting on an acquired company's financial statements is higher net assets for the acquired company on the acquisition date, because the assets and liabilities are stepped up to fair value and goodwill is recognised. In turn, this usually results in lower net income in periods subsequent to the acquisition, due to higher amortisation, higher depreciation and potential impairment charges. The typical pushdown impacts are illustrated in the table below.

Assets	↑	Impact of goodwill and step up in value of PP&E, intangibles, and inventory	**Revenue**	NEUTRAL	Future revenues could decrease if the fair value of acquired deferred revenue is less than book value
Liabilities	NEUTRAL	Liabilities could increase if contingencies are recorded at fair value	**Expenses**	↑	Impact of increased amortisation and depreciation expense
Equity	↑	Reflects value paid by buyer; typically exceeds book value	**Net income**	↓	Impact of increased expenses

Operating cash flows	NEUTRAL	Impact of pushdown is typically noncash	**EBITDA**	NEUTRAL	EBITDA could decrease if stepping up inventory results in increased cost of goods sold

Further considerations related to pushdown accounting

When considering pushdown accounting, it is important to *understand the needs of the users* of an acquired company's financial statements, and those needs may vary. Some users may prefer the stepped-up basis that results from pushdown accounting. Other users may prefer the historical basis to avoid distorting income statement trends as a result of increased amortisation and depreciation expense. Users that are focused on cash flow and EBITDA measures may be indifferent, as these measures are often not significantly affected by pushdown accounting. Assessing user needs may be more challenging when there are multiple users of the financial statements with different needs (e.g. creditors versus equity investors).

Some acquirers may prefer to apply pushdown accounting at the acquired company level to avoid separate tracking of assets, such as goodwill and fixed assets, at two different values (historical and stepped-up basis). Conversely, an acquired company may prefer to carry over its historical basis even when its acquirer is applying business combination accounting. Companies may also want to consider the tax reporting implications and may prefer to carry over their historical basis for financial reporting purposes when the carry over basis is being used for tax reporting (that is, when there is no tax step-up).

The question of whether pushdown accounting should be optional or mandatory for all acquirers needs to be considered. For example, under US GAAP, pushdown accounting is optional. In November 2014, the FASB issued guidance that gives all companies (businesses or non-profit entities) the option to apply pushdown accounting when they are acquired by another party (a change-in-control event). The option is available to the acquired company, as well as to any of its direct or indirect subsidiaries. Each acquired company as well as any of its subsidiaries may make their own elections independently.

On the other hand, US GAAP has not traditionally permitted new basis accounting, in part because of the practical difficulty of demonstrating that the reference transaction was indeed arm's-length in nature. (Obviously, the risk is that a series of sham transactions could be used to grossly distort the cost and hence carrying values of the entity's assets, resulting in fraudulent financial reporting.) The question of where the threshold should be set (a 50% change in ownership, an 80% change, etc.) to denote when a significant event has occurred that would provide valid information on the valuation of the entity's assets and liabilities for financial reporting purposes has also been widely debated.

Many of the more general issues of pushdown accounting (those applicable to traditional business acquisitions) have yet to be dealt with. For example, practical problems remain: while pushdown makes some sense in the case where a major block of an investee's shares is acquired in a single free-market transaction, if new basis accounting were to be used in the context of a series of step transactions, continual adjustment of the investee's carrying values for assets and liabilities would be necessary. Furthermore, the price paid for a portion of the ownership of an investee may not always be meaningfully extrapolated to a value for the investee company as a whole.

Besides that, pushdown accounting represents a new basis of accounting that is fundamentally different from the existing measurement basis of assets and liabilities. When considering the option for a new basis of accounting, to reduce the diversity in application, new comprehensive measurement basis for different assets and liabilities will have to be developed. In the meantime, even under financial reporting frameworks such a US GAAP, where pushdown accounting is allowed (and even required under certain circumstances), there are still no guidelines on recognising and measuring specific items in a subsidiary's financial statements when pushdown accounting is selected. Items such as contingent consideration, indemnifications, and transaction costs should be assessed for pushdown, depending on the specific facts and circumstances. For example, a contingent consideration liability would generally not be recognised in the acquired company's financial statements, unless the acquired company is the legal obligor. Transaction costs should generally be recognised as expense by the acquirer, and not pushed down to the acquired company. It is not always apparent whether certain assets and liabilities should be pushed down to the acquired company. However, regardless of what specific items are pushed down, goodwill recognised by the acquired company should generally equal goodwill recognised by the acquirer on the acquisition date.

Intercompany sales of goods between subsidiaries of a group

Another question that probably should be considered in the context of pushdown accounting is that how effects of intragroup transactions should be better reflected in subsidiaries' financial statements. For example, when subsidiary A purchases goods for 100 and sells to another subsidiary B of the group for 150, these goods are generally recorded at 150 at the subsidiary B level but at 100 at the group level..

Therefore, it could be considered to allow as part of the pushdown accounting in the post-acquisition records of the subsidiary B also to account the goods at 100, with the difference recorded in the capital to avoid two measurement bases.

Advantages and disadvantages of pushdown accounting for a subsidiary's financial statements

Advantages

- Pushdown accounting is based on the logic that, as under accounting for business combinations, the most objective gauge of cost is that arising from a recent arm's-length transaction. Therefore, this new basis should be used in the financial statements of all entities, including the related assets and liabilities to provide this objective cost.
- To some extent, this approach may provide simplification for the preparer, if using one basis of accounting, including better control over integrity of similar data.
- For users**,** the value may be achieved by using the same set of financial information based on the most recent transaction values rather than historical cost.
- For regulators and auditors, there is also some room for simplification, if one set of data is used.
- The optional use of pushdown accounting can help avoid many inconveniences (cons), for example, when companies may prefer to leave the historical basis for financial reporting purposes if they use the carry over basis for tax reporting.
- Allowing the option of pushdown accounting would make it easier to consider the needs of users of specific financial statements.

- Working out the rules for applying push-down accounting in a subsidiary's financial statements would help to avoid many of the cons mentioned below, such as manipulation of results and fraudulent reporting.

Disadvantages

- Typically, applying pushdown accounting results in higher net assets for the acquired company and lower profits in the post-acquisition period (due to higher impairment and depreciation). Higher net assets for the acquired company may disserve the debtholders and non-controlling shareholders (the main claimants of the financial statements eligible for pushdown), who can look only to the net assets of the acquired entity to satisfy their claims. In contrast, the controlling shareholders of the acquired entity can look to the net assets of the consolidated entity to satisfy their claims. The price paid for a portion of the ownership of an investee may not always be meaningfully extrapolated to a value for the investee company as a whole.
- Furthermore, introducing a one-time change in the carrying value of assets and liabilities will obviously make the time-series comparisons of changes in assets, liabilities and resulting income challenging for the primary users of a subsidiary's financial statements (such as debtholders and non-controlling shareholders). Step-up acquisitions introduce further issues because the continual adjustment of the investee's carrying values for assets and liabilities would be necessary.
- Companies may prefer to leave the historical basis for financial reporting purposes when the carry over basis is being used for tax reporting (and thus there is no tax step-up). Therefore, they will still have a burden of preparing more than one set of financial statements.
- In addition to the issues with the measurement basis of assets and liabilities in the financial statements of the acquired entity, there should be evidence of an arm's length transaction, because there is a risk that a series of sham transactions could be used to distort the cost and, hence, carrying values of the entity's assets, resulting in fraudulent reporting and other manipulations.
- There is also a risk that the option to use two different measurement basis would result in selecting the one that makes the reported results look better. This is especially relevant for retrospective application.

- Allowing the option of pushdown accounting would lead to using different bases in different cases, which undermines comparability and hinders the comparison of financial information between different entities and over time. The potential non-comparability in the basis of accounting used by acquired entities is quite significant. It would also lead to distorting historical trends by establishing a new basis of accounting for each change-in-control event, which may not be beneficial for many preparers and users. If pushdown accounting will be made optional, further consideration needs to be given to the independent selection of the new basis by each acquired entity within the group, which could lead to issues with the comparability of financial information and historical results even within one group of companies. It would be very confusing for users of the financial reports of the acquired entities within one group to review financial statements prepared using different measurement bases for the same assets and liabilities within consolidated and separate financial statements.
- Requiring mandatory application of pushdown accounting would result in a substantial increase in the number of entities applying pushdown accounting and also an increase in the frequency of pushdown accounting being applied by the same entity. This may not be beneficial to many users of financial statements and may be a costly exercise for many preparers.

Suggestions

Similarly to how business combinations are significant events that require a new basis of accounting for the net assets acquired, the change of control over a company may also be considered as a significant economic event to the acquired entity, and thus could seem to be a valid reason for re-measuring an entity’s net assets in its financial statements in order to provide a more faithful depiction of the transaction in certain circumstances. More recent information may be more valuable for users of financial statements. The use of pushdown accounting for a subsidiary’s financial statements may provide better control over integrity of similar data and simplification for the preparers, regulators and auditors as one set of data is used.

However, as outlined in this paper, there are many aspects that call into question the benefits of this approach to many users of the financial statements, and it may be a costly exercise for many preparers. Along with that, there are significant judgements involved in many areas when applying a new basis of accounting. Together with some intentional decisions, this may create risks of inappropriate accounting practices. Therefore, careful consideration needs to be given to user feedback and whether there are mixed views about the relevance and benefits of pushdown accounting.

Issue 4: Initial recognition of intercompany loans and intercompany guarantees at fair value

In light of the increasing turbulence on financial markets, diversification has become vitally important for the survival of businesses of various sizes. One response to market instability is the consolidation of different businesses under the umbrella of one owner or group of owners. The groups often include businesses from various industries and at different stages of their economic lives: some are mature and generate stable cash flows, while others may be at the early stages of development.

1) Intercompany loans

Resources are often redistributed between group entities through intercompany financing represented by various types of lending arrangements and loans. On the one hand, loans presume the repayment of the initial amount, and, on the other hand, represent a convenient and understandable way of distributing excessive cash to the owners or to other businesses that may need support.

Initially, all financial instruments should be recognised at their fair value. This guidance is similar in IAS 39 and IFRS 9. In practice, many loans between the different entities of a group may be issued at non-market rates (higher or lower than market, or zero percent). IFRS 9 5.1.1/IAS 39.43 allows and requires entities to recognise the difference between the fair value of the loan and consideration paid/received only when the fair value are Level 1 or 2 measurements, i.e. supported by the market quotation or derived from a model that has inputs only from observable markets. IFRS 13 Appendix A defines fair value as the “price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. At the same time, the related-party transactions may not always be exercised at market terms and conditions.

Thus, despite the fact that a financial instrument’s initial fair value is usually represented by the transaction price, there are many cases when the cash consideration might not be the instrument’s fair value. In related-party transactions, the counterparties may transfer to each other remuneration amounts that more or less compensate the time value of money, basic lending risks, transaction costs and the lender’s profit margin. In related-party transactions, it becomes critical to understand the substance of the transactions (what is behind the payments on the particular loan). In such situations, IAS 1.106 is definitive. It requires entities to account for transactions with shareholders acting in their capacity of shareholder within equity.

In the simplest scenario, Parent Company P gives or receives a zero-interest loan to/from the subsidiary and the loan is redeemable at some point in time. In this case, it is obvious that the loan is off-market and the nature of the transaction is either to support the entity by providing it with free financing or withdrawing some value from the company by not paying interest. Parent Company P in its ownfinancial statements should account for the difference between the fair value of the loan at the initial recognition and the consideration as the increase/decrease of investment. Subsidiary S's accounting mirrors that of its parent: the initial fair value adjustment is a contribution to equity or a distribution from equity, similar to dividends.

Upon consolidation, the investment in the subsidiary is eliminated from the consolidated financial statements with the corresponding entry to S's equity, as required by IFRS 10. Therefore, the contribution/distribution will not even be disclosed in the financial statements of the group.

Similar accounting consequences are relevant for loans with below-market interest rates. In this case, another complication is to assess whether the loan has a lower credit risk and requires less administration, which is reflected in the rate level, or whether there is something else hidden or embedded in that rate.

Even more sophisticated considerations arise in loans between sister companies. In this case, understanding the economic substance of the transaction is crucially important. Often, only the owner knows and is able to explain it.

Generally, disclosure of information about transactions between subsidiaries of a group at transfer pricing represent an issue. The intercompany gains and losses arising on such transactions 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 (non-controlling interest, NCI) of the subsidiaries. If, for example, the goods are sold at below market prices between the group companies, the NCI might lose part of the income it would have as available for distribution to him had the entity sold those goods externally. The non-controlling shareholders would not be aware of this information, but it might be useful for them. Therefore, it would be beneficial to disclose it, for example, as part of related party disclosures.

Once the rate is ascertained as non-market and the substance of the transaction is determined, the next step is determining the level of the market rates that would be appropriate to compensate the time value of money, basic lending risks of the particular borrower within the group, transaction costs and the particular lender's profit margin. This information may not be available for all entities within the group, since some may exercise only one function or represent a certain cost or profit centre.

The more complex and multilevel structures and transactions are, the more professional judgement may need to be exercised. The practical approach to this situation may be accounting for these types of loans at contractual nominal rates.

Advantages and disadvantages

The disadvantages of such approach are:

1. The measurement approach at the initial recognition and subsequently for the intercompany loans will be inconsistent with other financial instruments.
2. The real costs of borrowings and income on investments may not be possible to estimate.
3. Financial gearing and debt to equity ratios might be misstated, as well as EBITDA, depending on the nature of the business.
4. There is less comparability with peers due to the lack of consistency.

The advantages of this approach are:

1. The calculations are simplified.
2. There is no need for a market data search.
3. There is no need to involve experts.
4. Costs are lower, and less time and effort are spent on modelling.
5. As a result, the terms of the preparation of subsidiaries financial statements are potentially accelerated.

2) Intercompany guarantees

Another implication of market turbulence is the tightening of creditor requirements on the credit quality of loans and the search for additional sources that would guarantee the timely servicing of debt. Creditors (banks) issue loans to the particular legal entities within the group. In most cases, the parties understand that the borrowers obtain financing to inject liquidity not into a particular group entity but to the group as a whole. Banks may request additional collateral from the entities that are going to use the funds. The most common instrument to furnish such arrangements is to sign a financial guarantee contract or to get surety.

Financial guarantees are contracts that require the issuer to make specified payments to reimburse the holder for a loss it has incurred because a specified debtor has failed to make a payment when due in accordance with the original or modified terms of a debt instrument (IAS 39.9/IFRS 9 Appendix A).

In practice, a group entity that receives external funding usually acts like a corporate treasury. It may not have production operations or facilities at all, but rather collects available internal and external resources and distributes them to the group entities that need them. If external financing would be provided to that entity considered in isolation, the interest rate would be quite high due to its credit risk or the loan might not have been issued at all. On the other hand, if other healthy performing group entities would guarantee the loan, the decreased credit risk would be reflected in a lower interest rate.

In accordance with IAS 39 and IFRS 9, the guarantors must account for the issued financial guarantees. At the initial recognition, the guarantees are accounted for at fair value, which for externally issued guarantees is the amount of the commission charged. Subsequently, in terms of IAS 39, the carrying value of the guarantee is the higher of the amount of unearned commission at the reporting date and the amount of provision estimated in accordance with IAS 37 rules. In terms of IFRS 9, it is the higher of the amount of unearned commission at the reporting date and the amount of expected credit loss on the guarantee.

For the recipient of the guarantee, the accounting is not prescribed. Economically, the value of the guarantee is reflected in the decreased borrowing rate. Within group entities, guarantees are often issued free of charge.

Therefore, in terms of subsidiary’s or parent’s financial statements, the entity that issues the financial guarantee needs to estimate its fair value as the amount of hypothetical commission it would charge. The amount of commission should reflect the credit risk of the debtor, as well as the cost of servicing the guarantee, and the time factor and margin of the guarantor. In fact, the process is very similar to that of determining the contractual and effective interest rate on the loan.

Establishing the fair value may be difficult if the financial guarantee contracts are not negotiated at arm's length and there are no comparable observable transactions with third parties. Since intra-group transactions are unlikely to be negotiated on an arm's length basis, the fair value will have to be estimated. The most common approaches are as follows.

Reference to market prices of similar instruments

An entity may be unable to identify the market price for financial guarantees identical to those that it or a member of its group has issued. However, it may be possible to identify market prices for similar guarantees, credit default swaps or credit insurance products whose prices could be adjusted.

For example, Parent P has guaranteed USD 100m of five-year debt issued by Subsidiary S. It may be possible to identify credit insurance products issued by a bank related to debt of this amount, maturity and credit quality. However, an adjustment may still be necessary, for example, to reflect liquidity aspects and differences between Entity P's credit rating and that of the bank.

Interest rate differentials

Under this method, the entity calculates the value of the difference between the interest charged on the guaranteed loan and what would have been charged had the loan not been guaranteed. The premise is that the interest that the bank is willing to forego represents the price that it is willing to pay for the guarantee. For example, Parent P has guaranteed USD 100m of five-year debt issued by Subsidiary S. Subsidiary S pays interest of X% on the debt. In the absence of the guarantee, the bank would impose Y% interest. Hence, the fair value of the guarantee represents the difference in the present value of the interest payments over the period of the guarantee.

This model is simple in principle, but measuring Y% presents practical problems. It is unlikely that the bank would provide a reliable estimate. Determining Y% requires estimating the credit spread (for example, above a base index such as LIBOR) appropriate to Subsidiary S in isolation. This may prove difficult, as, even without a guarantee, Subsidiary S's credit rating would benefit from the entity being a member of Parent P's group. Nevertheless, models based on determining a standalone credit rating for Subsidiary S do exist and often enable a reliable estimate to be made.

Discounted cash flow analysis (expected value)

Instead of considering the price that a bank would pay for a guarantee, it might be possible to consider the price that the issuer would demand for accepting the guarantee. This can be estimated using a probability adjusted discounted cash flow analysis. For example, Parent P has guaranteed USD 100m of five-year debt issued by Subsidiary S. The probability of Subsidiary S defaulting is estimated at 0.04% (based on historical default rates among companies with the same credit rating) and the loss in the event of default is estimated at 50% (based on Subsidiary S's asset base and other collateral available to the bank). The expected value of the liability (its fair value) would, therefore, be USD 20,000.

Similar to the interest rate differential approach described above, this model is simple in principle, but presents practical problems when estimating the probability of default and the loss given default. Although data on these points are available, they rely on determining Subsidiary S's credit rating, as in the interest rate differential approach.

Having had established the fair value of the guarantee, the issuer needs to determine whether the difference between the fair value of the guarantee and the commission charged (if any) should be recognised as one-off expenses or the capital contribution by increasing the cost of investments into the subsidiary or other group entity. The economic substance of the transaction becomes critical in this case. In some cases, it may be possible to choose an accounting policy, depending on the overall approach of the group to this type of transactions. The choice should be applied consistently to all similar transactions and properly disclosed. If entities within the group have different policies, they should be aligned upon consolidation.

For a party whose borrowings are guaranteed (the debtor), the accounting policy and measurement approach should be developed, at least, for further consolidation. Question arises if, to achieve efficiency, accounting in the own financial statements of the guarantor and debtor should mirror each other.

For example, where Subsidiary S receives a loan that has been guaranteed with the bank by Parent P, Subsidiary S benefits from a lower interest rate on the loan (in comparison with an unguaranteed loan). Subsidiary S could (or should) fair value the loan from the bank by reference to the normal market rate of interest it would pay on a similar unguaranteed loan and take a benefit of the interest rate differential to equity as a capital contribution from Parent P. Alternatively, Subsidiary S may see a guaranteed loan as a unit of account and not separate the guarantee.

Ideally, if the guarantee is accounted by the guarantor through the income statement, the debtor should recognise it in the income statement as well. Alternatively, if the guarantor accounts for it as an increase of investment, the debtor should account for it as an equity contribution. Another accounting alternative is to gross up the borrowing fair value for the fair value of the guarantee.

In practice, there is a great deal of diversity in applying accounting policies. However, most subsidiaries do not separate received guarantees as capital contributions and account for them within the fair value of loans.

We have also observed some cases when intragroup guarantees are priced above market (more than 20% of the amount guaranteed), which also raises questions about the economic substance of the transactions.

All the above transactions and balances will be eliminated upon consolidation. Therefore, it may be appropriate not to recognise the free of charge or non-market valued financial guarantees in separate financial statements at all.

Advantages and disadvantages

The disadvantages of such an approach are:

1. The measurement approach at the initial recognition and subsequently for the intercompany free of charge financial guarantees will be inconsistent with the financial statements of peers.
2. The guarantors' separate financial statements will not contain all income and respective exposures for the purposes of segment and intragroup transactions analysis.
3. The real costs of borrowings and income on loans issued may be misstated.
4. Potential issues with the completeness of the off-balance sheet exposures at the group level.

Advantages of such approach are:

1. The calculations are simplified.

2. There is no need for a market data search.
3. There is no need to involve experts.
4. The costs are lower, and less time and effort are spent on modelling.
5. As a result, the terms of the presentation of the separate financial statements are potentially accelerated.
6. If the guarantees are free of charge, the financial statements of both parties need no adjustments.
7. Inconsistent practices are eliminated.

Issue 5: Measurement of assets and liabilities in a legal entity own financial statements: fair value versus cost

Current requirements

IAS 27 includes a definition and a number of specific accounting requirements (for example, specific requirements for investments in subsidiaries) for preparation of a legal entity own financial statements. The standard permits entities to measure investments in subsidiaries in any one of three ways. These are at cost, using the equity method under IAS 28, or at fair value in accordance with IFRS 9. In most cases, companies use cost basis measurement due to the difficulties and costs related to fair value measurement and application of equity method. All other assets and liabilities (apart from investments in subsidiaries, jount ventures and associates) should be measured and accounted for in accordance with the relevant IFRS. However, it may be reasonable to expect that other simplifications may be permitted for measuring other assets and liabilities (for example, relief from fair value measurement).

A growing number of standards require fair value measurement:

- IFRS 9 requires fair value measurement for all investments in equity instruments (option to accounting at cost for non-traded equity shares is removed started from 2018) and derivatives and for some debt securities;
- IAS 41 requires all biological assets to measure at fair value less cost to sell with some exemptions;
- IFRS 5 requires measure non-current assets and disposal group held for sale at the lower of its carrying amount and fair value less cost to sell;
- IFRS 2 requires fair value measurement for all share-based transactions;
- IFRS 15 requires to measure revenue at fair value;
- If entities establish post-employment benefit plans, they should recognise plan assets at fair value under IAS 19.

The issue

In all cases when IFRS requires fair value measurement, the entities should apply IFRS 13, which requires the use of judgement. During phase 1 of the PIR of IFRS 13, some stakeholders stated that making these judgements is challenging. It is also worth considering the results of a study conducted by the Korea Accounting Standards Boards (KASB) after South Korea had adopted IFRS.[1] The survey examined the costs and benefits of adopting IFRS from the perspective of preparers of financial statements. According to the study, approximately one-half of the respondents replied that the costs of adopting IFRS exceeded the benefits, and only around 10% of the respondents replied that the benefits exceeded the costs. Among the difficulties the respondents faced in preparing financial statements after adopting IFRS was fair value measurement (more than 20% of respondents).

Suggestions

Taking into account the response of preparers and cost-benefit balance, there are arguments for simplification of the measurement of certain assets and liabilities in subsidiary's financial statements. To achieve this the following would need to be addressed:

1) Should the historical cost basis be optional as an accounting policy or required in a subsidiary's 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?

Impact of cost basis measurement on financial statements

Departing from fair value measurement and using the cost basis could have the opposite effect on figures in financial statements, depending on whether market changes are favourable

[1] Research Report #37 "Costs and benefits of IFRS adoption in Korea: Preparer perspectives", June 2015

for the entity. Therefore, it cannot be said that using fair value or, conversely, cost basis will improve liquidity, solvency and creditworthiness ratios. However, one this is for certain: using the cost basis will make profit or loss less volatile and some of the users will respond positively.

Considerations related to accounting at cost, advantages and disadvantages

1) *Who are the users and what are their needs?* In general, the objective of consolidated and legal entity financial statements are different. To improve the usefulness of information presented in different sets of financial statements, preparers should first consider who are the users of the information: debt or equity investors (if equity investors, then whether they are value investor (seek stocks that appear to be undervalued by the market) or growth investor (seeks companies that offer strong earnings)). Another group of users are legal and regulatory authorities. Although these users can require legal entities to prepare the information they need, such authorities often look at general purpose financial statements as the starting point of their assessment. The financial statements of a legal entity are often used to assess the company's financial position and compliance with local regulations. This includes statutory filing according to commercial and bankruptcy laws, and capitalisation requirements (e.g. insurance and banking industry). Financial statements by legal entity are frequently used by management as well (for example, to make management decisions about investments in intermediate parents and subsidiaries). The information needs of these users will vary. In other words, preparers need to consider what type of decisions the users make on the basis of the financial statements and, consequently, what information they need to make those decisions (for example, an assessment of an entity's creditworthiness, its capacity to generate cash flow to repay debt or distribute dividends). Management is responsible for knowing whether their investments are well capitalised, their financial statements comply with local statutory obligations and the entity is capable of distributing dividends.

Based on this, the entity should use the most appropriate measurement basis: fair value versus cost. Below are the aspects that need to be considered after determining the users and their information needs.

2) Current market conditions. Fair value measurement allows financial statements to reflect the impact of current market conditions on financial instruments and other assets and liabilities, and provides users with timely information about changes in the market. In other words, fair value increases the transparency of the impact of market forces on financial information. Re-measurement at fair value results in recognising gains and losses due to changes in market prices when they arise (these amounts are included in financial results of the entity over time). Conversely, when the entity uses the cost basis, these amounts are deferred until the disposal of assets and liabilities. We have already noted that one of the decisive factors is the identities and needs of users of financial statements. If the users are investors with a desire to know the current values of assets and liabilities, then the fair value measurement should be used. If financial statements do not provide this information, investors and creditors will turn to other sources of information, resulting in increased costs and inefficiencies. It could be said that investors' needs to receive timely information might outweigh the disadvantages of fair value measurement.

3) Ability to assess future cash flows. As stated in the *Conceptual Framework*, para OB3, economic decisions that are taken by users of financial statements "depend on their assessment of the amount, timing and uncertainty of future net cash inflows to the entity". Would a cost-based set of financial statements help users assess the amount, timing and uncertainties of future cash flows? Obviously not. The same conclusion might be made on the basis of feedback received from the respondents of PIR of IFRS 13.[2] The respondents (which included preparers, valuation specialists, a user, a regulator, a standard-setter and an auditor) discussed the effect of IFRS 13 on users' ability to assess future cash flows. Many thought IFRS 13 had improved users' ability to assess future cash flows. If we talk about current or potential non-controlling investors as users of a subsidiary's financial information, fair value measurement would be the most appropriate measurement basis.

4) *Predictive value.* Another argument in favour of fair value measurement is the predictive value of financial information. Once again recall the *Conceptual Framework*. It states that financial information is capable of making a difference in decisions, particularly if it has predictive value. We understand that entities do not need to predict the future, but information will have predictive value only if it can be used as an input to processes employed by users to predict future outcomes. Fair value measurement may have higher predictive value than cost.

5) Comparability. This is another qualitative characteristic of financial information. Information about a reporting entity is more useful if it can be compared with similar

[2] IASB, "Post-implementation review of IFRS 13", Staff paper, March 2018

information about other entities and with similar information about the same entity for another period or another date (*Conceptual Framework*, para QC20). According to a staff paper on PIR of IFRS 13, most respondents stated that the issuance of IFRS 13 has improved comparability between different reporting periods for an individual entity and between different entities in the same reporting period. It is clear that single historical cost transactions for the same asset or liability concluded on different dates will give different values.

6) *Compliance costs.* This may be stated as the greatest advantage of the historical cost basis. We mentioned earlier the research of cost-benefit analysis conducted by KASB and the difficulties and costs for preparers of financial statements due to fair value measurement. The same is true for all preparers applying IFRS. PIR of IFRS 13 has indicated that compliance costs were considerable, with some respondents stating that additional costs were considerable due to external audit fees and valuation specialist fees. A few respondents stated that considerable costs were incurred when determining the fair value for items that do not have an active market. Unquoted equity instruments were also mentioned. Considering that IFRS 9 removes the possibility of measurement at cost for unquoted instruments (starting from 2018), we can expect that these costs will increase significantly for some entities. Therefore, allowance of accounting at cost would reduce the efforts of preparers and their costs on fair value measurement.

7) Reliability. While many agree that fair value yields a more relevant measure than historical cost, it is not perfect. Two controversies surround fair value measurements today: (1) the application of fair value accounting in illiquid markets, and (2) how and when modelling should be used. The methods and models used for fair value measurement include assumptions, judgements and estimates that may result in non-market values. In contrast, accounting at cost is based on real transactions.

8) Volatility of profit and loss. Fair value measurement gives rise to gains and losses in the income of profit or loss due to changes in market prices. This means that the financial results of entities to some extent do not depend on management’s operational and financial decisions. There may be situations when market conditions result in large write-downs through the application of fair value measurement (i.e. the 2008 financial crisis). The requirement to use fair value measurements have been criticised for producing inaccurate results in the unusual market conditions experienced in 2008. Such results, it is argued, hurt companies in the long run. If a company must record losses in such an environment, critics claim, it signals bad news to investors that may ultimately be misleading. As a result, IASB amended IAS 39, which helped companies to escape from recognising a large amount of losses in their financial results.

9) Two measurement bases for two sets of financial statements. This results in a sort of asymmetry of financial information presented in two sets of financial statements: consolidated and of a legal entity. It is obvious that preparing two sets of financial statements with different measurement bases is burdensome for entities. Different bases for the same items might also be confusing for users. If we talk about true and fair presentation, this would return us back to the question about the kind of information that different investors or other users need in order to make economic decisions.

Considerations related to accounting in a subsidiary's financial statements of internally generated intangible assets and contingent liabilities at fair value

Another question that is worth to highlight is the recognition of internally generated intangible assets and contingent obligations in a subsidiary's financial statements. The objective of financial statements is to provide financial information about the reporting entity that it is useful to existing and potential investors, lenders and other creditors. IAS 38.63 prohibits the recognition of internally generated brands, mastheads, publishing titles, customer lists and items similar in substance, since these expenditures cannot be distinguished from the cost of developing the business as a whole. IAS 37 also prohibits recognition of a contingent liability. If we assume that the fair value is a reliable basis for measurement, then maybe it is worth recognising these assets and liabilities at fair value as an accounting policy choice if the financial statements of the subsidiary are prepared for M&A transactions or business valuations.

Conclusion

The objective of a subsidiary's financial statement differs from the objectives of consolidated financial statements. Defining the users of these two types of financial statements and their informational needs should be decisive for consideration whether to give preparers the option of choosing an accounting policy. As outlined in this paper, there are many advantages and disadvantages for both the fair value and cost basis, each of which have to be considered thoroughly. Attention should also be paid to the feedback received from the respondents of PIR of IFRS 13 (published in March 2018).

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

Current requirements

Groups may decide to reorganise their structure for a number of reasons. In a reorganisation, the subsidiary of the group receives financial assets and recognises them in itsfinancial statements. IFRS 9 does not contain specific measurement guidance for these financial assets. Preparers need to apply common requirements.

The issue

From the perspective of the subsidiary, this is initial recognition. Therefore, these assets initially are recognised at fair value, plus transaction costs, in accordance with IFRS 9.5.1.1. On the other hand, transactions should be presented in the financial statements based on their commercial substance, i.e. with the principle of “substance over form”. If so, the cost of received financial assets should not differ after reorganisation, i.e. the subsidiary should be able to use measure on the basis of the predecessor value.

Suggestion

There are arguments for developing a guidance on measurement (for example, predecessor value basis) of financial assets received by a subsidiary in a reorganisation. Both approaches (fair value and predecessor value basis) have advantages and disadvantages. Analysis for debt and equity instruments need to be provided separately due to different measurement bases stated by IFRS 9.

Equity instruments. Starting from 2018, all equity instruments after initial recognition should be measured at fair value. This means that the entity re-measures these assets at fair value at each reporting date. Therefore, the difference between fair values at the most recent reporting date and the date of reorganisation should be insignificant if the market is not highly volatile. As such, we can say that this question is not of overwhelming importance for equity instruments.

Debt instruments. Unlike equity instruments, most debt instruments after initial recognition are measured at amortised costs using the effective interest method (IFRS 9.5.4.1), i.e. ignoring market changes. These assets are subject to impairment (IFRS 9.5.5.1). Even in the case of impairment, the carrying value of the instrument might differ from its market value, since expected credit losses should be calculated using the effective interest rate determined at initial recognition (IFRS 9.B5.5.4). Thus, the fair value of debt instruments might differ from its carrying amount on the predecessor's financial statements.

The following questions must be addressed:

1) Should a company be allowed to initially recognise financial assets received in a reorganisation at the predecessor value basis?
2) If yes, should this be optional or mandatory?
3) 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?

Impact of measurement on predecessor value basis on financial statements

Initial recognition on the predecessor value basis in comparison with fair value might be favourable for the entity, depending on changes in market interest rates. In any case, the measurement basis will have neutral impact on EBIT/EBITDA, since financing income is not included in this performance indicator.

Considerations related to the predecessor value basis, advantages and disadvantages

Most aspects that have to be considered for this issue are noted above (issue 5). First, entities should consider the purpose of their financial statements, including the users and their informational needs, and, of course, the costs and challenges related to fair value measurement.

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

Joint arrangements are frequently used to run operations in different industries (e.g. oil and gas, mining, pharma, construction) as a way to share the higher risks and costs associated with the industry or as a way of bringing in specialist skills to a particular project. The legal basis for a joint arrangement may take various forms. Establishing a joint arrangement might be achieved through a formal contract, or the governance arrangements set out in a company's formation documents might provide the framework for a joint arrangement. The feature that distinguishes a joint arrangement from other forms of cooperation between parties is the presence of joint control. A jointly controlled entity may be either a joint operation or a joint venture. The classification of the joint arrangement is based on the rights and obligations of the parties to the arrangements.

Joint venturers have rights to net assets and account for their investments using the equity method. The arrangement is a joint operation where the contractual agreement provides rights to assets and obligations for liabilities for those parties sharing joint control.

Current requirements relating to accounting for the joint operations in a subsidiary's financial statements

Determining the type of joint arrangement can be complex under IFRS 11. Legal form is relevant for determining the type of joint arrangement. A joint arrangement that is not structured through a separate vehicle is a joint operation. However, not all joint arrangements in separate vehicles are joint ventures. A joint arrangement in a separate vehicle can still be a joint operation. The classification depends on the rights and obligations of the venturers and is further influenced by the economic purpose of the joint arrangement.

A separate vehicle is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality. The definition of *separate vehicle* is quite broad. It does not necessarily need to have a legal personality. This paper refers to the situation when the joint operation is run in a separate legal entity.

Joint arrangements that are run in a separate legal entity may be classified either as a joint operation or a joint venture, depending primarily on whether:

i. the terms of the contractual agreement binding the parties sharing joint control override the legal form of the arrangement providing the investors with direct rights to assets and obligation for liabilities; or
ii. other relevant facts and circumstances indicate that investors have direct rights to assets and obligation for liabilities even if legal form and contractual arrangement would indicate otherwise. An example when other facts and circumstances indicate that parties to a joint arrangement have rights to the assets of the joint arrangement and obligation for liabilities is where the parties have the obligation to acquire substantially all of the economic benefits (output) of assets of the arrangement and as a consequence of their rights to, and obligations for, the assets of the joint arrangement, they provide cash flows that are used to settle liabilities of the joint arrangement.

In relation to its interest in a joint operation, a joint operator should recognise:

- Its assets, including its share of any assets held jointly.
- Its liabilities, including its share of any liabilities incurred jointly.
- Its revenue from the sale of its share of the output arising from the joint operation.
- Its share of the revenue from the sale of the output by the joint operation.
- Its expenses, including its share of any expenses incurred jointly.

The joint operator is required to account for its rights and obligations in relation to the joint operation. Those rights and obligations are the same, whether separate or consolidated financial statements are prepared. Therefore, the same accounting is required in the consolidated financial statements and in the 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.

Where a joint operator acquires an interest in a joint operation, the accounting treatment depends on whether the activity of the acquired joint operation constitutes a business. The joint operator should apply business combination accounting under IFRS 3 and other IFRS that do not conflict with IFRS 11 guidance, to the extent of its share, where the activity of the joint operation constitutes a business. This applies to the acquisition of both the initial interest and additional interest in a joint operation in which the activity of the joint operation constitutes a business. If the joint operation is not a business, consideration paid is allocated to assets acquired, and the investor recognises its share of liabilities assumed.

The issue

The accounting for a joint operation that is a separate legal entity adds significant complexity to the preparation of subsidiaries financial statements and is more burdensome than the accounting for arrangements that may otherwise be considered similar but are controlled by an investor instead of jointly controlled.

Suggestions

Financial statements prepared under IAS 27 requirements are financial statements that present the assets and liabilities of a legal entity. Therefore, the activities run by the legal entity through, for example, its subsidiaries are recognised as investments in accordance with para 10 of IAS 27 (i.e. broadly at costs, fair value or equity method). Recognition of these activities as investments reflects the legal boundaries of the investor and investee rather than the rights that the investor has for assets and obligation towards liabilities of the controlled investee. The legal boundaries are overridden in the consolidated financial statements of an investor presenting the group as one entity.

The recognition of different types of investments held by a legal entity (i.e. investments in subsidiaries, joint arrangements, associates) should be governed by similar rules in the financial statements of an investor as a legal entity. The accounting for joint operations run by an investor through separate legal entities may seem to be inconsistent with the general concept applied in the samefinancial statements for accounting for the entity's involvement in subsidiaries where the legal boundaries are a decisive factor. For example, the consideration of other relevant facts and circumstances may lead to the classification of a joint arrangement run as a separate legal entity as a joint operation, which would result in recognition of the investor's share of assets, liabilities, income and expenses in its separate financial statements. The same facts and circumstances if the entity is controlled by an investor would not result in recognition of the subsidiary's assets, liabilities, income and expenses, but a parent would recognise the investment in the subsidiary that is a separate legal entity measured in accordance with IAS 27 para 10.

Example

Two entities, A and B, form a limited liability company over which they have joint control. The limited liability company is formed to build and use a pipeline to transport gas. Entity A and Entity B have a 55% and 45% interest, respectively.

Under their contractual terms, Entities A and B must each use 55%/45% of the pipeline capacity. Unused capacity is charged at the same price as used capacity. Entities A and B can sell their share of the capacity to a third party without consent from the other investors. The price that entities A and B pay for the gas transport is determined in a way that ensures that all costs incurred by the company can be recovered.

The joint arrangement is structured through a separate legal entity. The contractual terms require a specific level of usage by each party and, because of the pricing structure, the entities have an obligation for the company's liabilities. This entity is a joint operation, despite its legal form. Each investor should recognise its share of assets, liabilities, income and expenses of the joint operation in its consolidated and financial statements prepared under IAS 27.

Should the contractual terms provide an Investor A with control, and Investor B with significant influence, with all other facts being the same, Company A would recognise the investment in subsidiary measured at cost, fair value or equity method in its financial statements under IAS 27.

Having the same rights to assets and obligation towards liabilities, Investor A would reflect them differently in its financial statements due to the fact that in one arrangement Investor A has joint control and in another it has control.

Considering the above, there are arguments for simplification of the IFRS 11 requirements for the financial statements of an investor in a joint operation and allow the investor 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).

Advantages and disadvantages

Advantages:

- Simplifies the preparation of financial statements by legal entity,
- Aligns the accounting for the jointly controlled operations with the similar arrangements run through entities that are controlled by the parent.

Disadvantages:

- May not reflect the economic substance of the arrangement and the investor’s rights and obligations.

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

Tax consolidation, or *combined reporting*, is a regime adopted in the tax or revenue legislation of a number of countries in which a group of wholly owned or majority-owned companies and other entities (such as trusts and partnerships) are treated as a single entity for tax purposes. This generally means that the head entity of the group is responsible for all or most of the group's tax obligations (such as paying tax and lodging tax returns).

Assets can be transferred between group companies without triggering a tax on gain for the company receiving the assets, dividends can be paid between group companies without incurring tax liabilities, and the tax attributes of one group company can be used by other group companies. In some jurisdictions, there may be other benefits, such as the ability to look through the acquisition of shares of acquired companies to depreciate the underlying assets.

For example, in Russia a group of companies may form a consolidated tax group (CTG) and select a responsible taxpayer (RT) to:

1. calculate the consolidated income tax of CTG;
2. pay the consolidated income tax of CTG to the relevant budget;
3. pay income tax advances to the relevant budget;
4. allocate consolidated income tax of a CTG among CTG participants and identify income tax contributions of each CTG participant to make to the responsible tax payer.

The responsibilities of other CTG participants include:

- calculating income and expenses for tax purposes, measuring its own current and deferred taxes, preparing tax registers and submitting them to the RT;
- transferring cash to the RT in amount of income tax contributions calculated by the RT, and for relevant tax penalties and tax deficiencies.

Calculation of the consolidated income tax of a CTG

The calculation for the consolidated income tax of CTG can be illustrated in formula:

Consolidated income tax =
((income of participant 1 + income of participant 2 + … + income of participant n) –
*(expenses of participant 1 + expenses of participant 2 + … + expenses of participant n)) **

income tax rate

Allocation of consolidated income tax among CTG participants

Even though just one amount of tax is assessed for the consolidated CTG group, tax should be allocated between entities for their individual financial reporting. Hence, each CTG entity recognises its own current and deferred tax balances and income tax expense. There are various methods that can be utilised for the allocation.

Current requirements

IFRS does not contain specific guidance for income tax accounting for consolidated tax groups. Below is an example of the allocation based on the share of nominal tax base (nominal tax base is tax base of each CTG entity submitted to the RT) of a CTG participant in sum of nominal tax bases of all CTG participants.

The RT estimates consolidation difference as the consolidated income tax minus the sum of the nominal income taxes of the CTG participants. For example, one CTG entity may have tax losses and no income tax expenses. The consolidated income tax base would include these losses. Therefore, the consolidated income tax of the CTG might be less than the sum of nominal income taxes of CTG participants by tax effect of losses of lossmaking CTG participant to the extend those losses are allowed to decrease the taxable income of CTG.

Consolidation difference is allocated among CTG participants, except for lossmaking CTG participants, as follows:

*Consolidated difference * (nominal tax base of a CTG participant / sum of nominal tax bases of CTG participants).*

Example. Allocation of consolidated income tax among CTG participants

The CTG includes the entities, one of which has losses in the current period.

Narrative	Formula	Responsible participant	Participant 1	Participant 2
Income	[1]	10,000	20,000	5,000
Expenses	[2]	(5,000)	(11,000)	(8,000)
Nominal current tax base	[3] = [1] + [2]	5,000	9,000	(3,000)
Tax rate	[4]	20%	20%	20%
Nominal tax	[5] = [3] * [4]	(1,000)	(1,800)	-

Consolidated income tax = ((10,000 + 20,000 + 5,000) – (5,000 + 11,000 + 8,000)) * 20% = 11,000 * 20% = 2,200

Consolidation difference = (1,000 + 1,800) – 2,200 = (600)

Consolidated difference for responsible participant = (600) * 5,000 / (5,000 + 9,000) = (214)

Consolidated difference for Participant 1 = (600) * 9,000 / (5,000 + 9,000) = (386)

Consolidation difference is not allocated to lossmaking CTG participants.

The issue

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

Suggestions

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

Advantages and disadvantages

Exemption from recording income taxes in a subsidiary's financial statement would significantly simplify the accounting, because there would not be need to make complex allocations of the consolidated tax to separate tax group entities.

The main disadvantage of such an exemption is that comparability with entities not being part of CTG may suffer.

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

Current requirements

In accordance with IAS 23.8, *an entity shall 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.* The standard distinguishes between funds that are specifically borrowed to finance the construction of a particular asset (IAS 23.12: To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.) and funds borrowed generally (IAS 23.14: To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.)

The issue

Calculation of the amount of borrowing cost that is to be capitalised is a very complex exercise, as the average interest rate of borrowings changes over the year due to changes in borrowings due to additional borrowings, repayments and amortisation. Combined with the changes in the construction in progress, the measurement of the amount of borrowing cost to be capitalised is complex, and requires judgment. IAS 23.11 also acknowledges these difficulties:

> It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or

linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.

If a subsidiary has raised a specific borrowing to construct an asset, the amount of borrowing cost capitalised is the same in the subsidiary's financial statements as well as in its parent's consolidated financial statements. Issues arise when the construction of the asset is financed by general borrowings, in the following circumstances:

1. The subsidiary has available cash and no borrowings and thus does not capitalise borrowing cost. The group (either parent or a fellow subsidiary) has borrowings and thus the parent needs to capitalise borrowing cost in its consolidated financial statements.
2. The subsidiary has intragroup borrowings and thus needs to capitalise borrowing cost. The group has no borrowings and thus there is no borrowing cost to be capitalised in its consolidated financial statements.
3. Both the subsidiary and group have borrowings, but these are at different interest rates, as the group entities are not necessarily in the same geographical location and/or industry, and the credit risk profile of different entities may be different.

In all the above cases, when the impact of the capitalised borrowing costs is material, significant adjustments need to be made in the parent's consolidated financial statements during the period of construction, as well as throughout the useful life of the constructed assets.

Until 2009, IAS 23 provided the policy choice between capitalising and immediately expensing the borrowing cost. The change was introduced as a result of the Short-Term Convergence project, whose objective was to reduce differences between IFRS and US GAAP (IAS 23.BC2). While it may be argued that converged accounting policies are essential to comparing the consolidated financial statements of (listed) entities, full convergence is not so crucial for legal entities financial statements, which are often issued solely to meet statutory reporting purposes, rather than to provide information to a wide range of stakeholders about the business controlled by that entity.

The *Conceptual Framework* also notes that (QC35): "Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information".

For cost-benefit reasons, capitalisation of borrowing cost is prohibited in IFRS for SMEs (IFRS for SMEs, BC 120).

The ultimate impact of capitalising the borrowing cost is often not very material. It may be material during the period of construction when the borrowing cost is not expensed, but it is almost always immaterial during subsequent years, as the impact of the capitalised borrowing costs on annual depreciation is usually very minimal. Therefore, considering the complexity of the area, the usual purpose of preparing financial statements by subsidiaries, and the requirement that the cost of preparing financial statements should not exceed the benefits for the users, simplifications would be supportable.

Suggestions and its advantages and disadvantages

The following simplifications could be adopted:

1. Restoring the accounting policy choice between capitalising and expensing the borrowing cost in a subsidiary's financial statements.

Advantage

- Ø Expensing borrowing costs significantly reduces the complexity of preparing the subsidiary's financial statements.

Disadvantage

- Ø Restoring the policy choice in a subsidiary's financial statements contradicts the IASB's general aim of achieving convergence with US GAAP to the extent possible.

2. Introducing 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.

Advantages

- Ø This simplification would help to avoid any double work at the subsidiary and parent level. The borrowing cost from specific borrowings is capitalised in the same amounts in the subsidiary's financial statements and the parent's consolidated financial statements. Only the parent would need to undertake complex calculations for the general borrowing costs when preparing its consolidated financial statements.

- Ø Possibility to choose to expense general borrowing costs significantly reduces the complexity of preparing the subsidiary's financial statements.

Disadvantages

- Ø Restoring the policy choice (or prohibiting the capitalisation of general borrowing costs) in a subsidiary's financial statements contradicts the IASB's general aim of achieving convergence with US GAAP to the extent possible. Judgments to distinguish between specific and general borrowings could become more critical and susceptible to bias.
- Ø Different accounting policies may decrease comparability and complicate understanding by users of the subsidiary's financial statements.

3. Allowing subsidiaries in their financial statements to use the capitalisation rate that is used by their parent in preparing consolidated financial statements.

Advantages

- Ø Including borrowings of a parent and its subsidiaries into one pool and using the group's 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 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.
- Ø This simplification would avoid accounting for borrowing costs differently at the level of the subsidiary and the consolidated level

Disadvantage

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

The simplifications described above could be restricted to entities whose debt or equity are not publicly traded.

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

Certain expenses might be incurred at the parent level and might be re-invoiced to the subsidiaries. Examples of such expenses include, but are not limited to pension, payroll, rent, centralised purchasing, executive management and advertising.

The question may arise as to whether the financial statements of the subsidiaries should reflect a reasonable allocation of expenses from the parent when such expenses are not re-invoiced.

Current requirements

There is no general requirement in IFRS to allocate expenses incurred at the parent level when such expenses are not re-invoiced. However, paragraphs 43A-43D of IFRS 2 “Share-based Payments” contains relevant guidance for group share-based payment arrangements.

Example 1. Group share-based payments arrangements: parent entity grants share awards to subsidiary employees

A parent grants its shares directly to the employees of subsidiaries A and B. The awards will vest immediately, and the parent will issue new shares directly to the employees. The parent will not charge subsidiaries A and B for the transaction.

In the consolidated financial statements, the transaction is treated as an equity-settled share-based payment, because the group has received services in consideration for the group's equity instruments. An expense is recognised in the group income statement for the grant date fair value of the share-based payment over the vesting period (immediately in this example) and a credit is recognised in equity.

In the subsidiaries' accounts, the award is treated as an equity-settled share-based payment, because the subsidiaries do not have an obligation to settle the award. An expense for the grant date fair value of the award is recognised over the vesting period and a credit is recognised in equity. The credit to equity is treated as a capital contribution, because the parent is compensating the subsidiaries' employees with no recharge to the subsidiaries. In this example, the shares vest immediately. An expense is recognised in the subsidiaries' income statement in full (based on the grant date fair value), and there is a credit to equity.

In the separate financial statements, the parent entity records a debit, recognising an increase in the investment in the subsidiaries, and a credit to equity, because the employees are not providing services to the parent. These accounting entries are recognised over the award vesting period (immediately in this example).

Reference to standard: IFRS 2 paras 43A–43D

Example 2. Group share-based payment arrangements: parent grants cash-settled awards to subsidiary's employees

A parent grants share appreciation rights to subsidiary A's employees. At the end of two years, the parent will pay cash to the employees equivalent to the difference between the share price on vesting and the share price at grant date. No intra-group recharge is to be made.

In the consolidated financial statements, the transaction is treated as a cash-settled share-based payment, because the group has received services in consideration for cash payments based on the price of the group's equity instruments. An expense is recognised in the group income statement for the fair value of the share-based payment over the vesting period, and a liability is recorded as the other side of the entry. This liability is re-measured at each reporting date until settlement.

In Subsidiary A's financial statements, IFRS 2 requires the award to be treated as equity-settled, because the subsidiary does not have an obligation to settle the award. An expense is recognised in the subsidiary's income statement over the vesting period, and a credit is recognised in equity. The credit to equity is treated as a capital contribution from the parent, because the parent is compensating the subsidiary's employees at no expense to the subsidiary.

The employees are not providing services to the parent, so there is no share-based payment remuneration expense recorded in the parent's separate financial statements. Instead, the share-based payment transaction results in a debit to investment in a subsidiary, and a corresponding liability is recorded at fair value at each reporting date.

Measurement would vary between the two sets of accounts.

Reference to standard: IFRS 2 paras 43A–43D

The issue

As mentioned above, there is no similar guidance in IFRS for 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 (e.g. pension, payroll, advertising, rent, etc.) 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, because the parent is compensating the subsidiaries' expenses with no recharge to the subsidiaries. This approach has also its analogy with the push-down accounted discussed earlier in this paper.

Advantages and disadvantages

The key benefit from allocating expenses from the parent is that the financial statements of a subsidiary would reflect all economic activity arising from the business of the subsidiary (no matter the source).

Disadvantages:

- This proposal applies only if the parent does not re-invoice the subsidiary;
- Determining the basis for allocation and measurement might be complex or arbitrary (the parent may re-invoice at cost, with a reasonable profit margin or otherwise);
- The allocation would involve additional effort for the subsidiaries or parent.