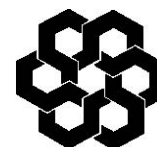


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Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate
(amendments to IFRS 1 and IAS 27)

Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards and IAS 27 Consolidated and Separate Financial Statements—Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate was issued in May 2008.

Introduction

This project report is structured as follows:

- [Objective](#)
- [Summary of amendments](#)
- [Background and project history](#)
- [Contact information](#)

Objective

1. The Board's objective in this project was to address issues that have arisen in practice related to accounting for investments in subsidiaries, jointly controlled entities and associates in separate financial statements at cost in accordance with paragraph 38(a) of IAS 27 *Consolidated and Separate Financial Statements*. In particular, the Board addressed:
 - concerns that retrospectively determining cost on first-time adoption of International Financial Reporting Standards (IFRSs) cannot, in some circumstances, be achieved without undue cost or effort. Consequently, this might create a barrier to entities' adoption of IFRSs in separate financial statements.

- the application of the cost method, including the accounting for dividends received from investments in subsidiaries, jointly controlled entities and associates.
- the measurement of cost in the separate financial statements of a new parent formed in a specific type of reorganisation.

Summary of Amendments

2. The **amendments to IFRS 1** allow first-time adopters, in their separate financial statements, to use a deemed cost option for determining the cost (in accordance with paragraph 38(a) of IAS 27) of an investment in a subsidiary, jointly controlled entity or associate. The deemed cost of such an investment shall be its:
 - fair value (determined in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*) at the entity's date of transition to IFRSs; or
 - previous GAAP carrying amount at that date.

A first-time adopter may choose either deemed cost option to measure its investment in each subsidiary, jointly controlled entity or associate that it elects to measure using a deemed cost.

3. The **amendments to IAS 27** remove the definition of the 'cost method' from paragraph 4 of that standard. Additionally, when an entity reorganises the structure of its group by establishing a new entity as its parent (subject to specific criteria), the amendments require the new parent to measure cost (for the purpose of paragraph 38(a) of IAS 27) as the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

Background

4. In March 2006, the Board added a project to its technical agenda to consider issues related to the determination of the cost of an investment in a subsidiary in the separate financial statements of a parent on first-time adoption of IFRSs. The issues were divided into two categories: the determination of the initial 'cost' of an investment in a subsidiary in accordance with IAS 27.38(a) and the subsequent measurement of that cost in the separate financial statements of the parent to reflect dividend receipts from the subsidiary.

Determining the initial cost in accordance with IAS 27.38(a)

5. In many jurisdictions (including most EU member countries) listed companies have a choice of preparing the separate financial statements of parent entities in accordance with either local GAAP or IFRSs. Many entities have continued to use local GAAP. The reason most often cited for this is the need to apply the IAS 27 cost method for investments in subsidiaries with full retrospective effect. Many argue that this requirement is at best, expensive in terms of time and money even if the necessary records are still available and, at worst, impracticable.
6. The use of merger relief accounting in the United Kingdom and other countries is a case in point. Under merger relief accounting, any shares provided as consideration for the purchase of an investment in a subsidiary are recorded (for the purposes of cost) at a nominal value. This nominal value is viewed by many as not being an IAS

27 compliant 'cost', which requires the investment to be measured initially at cost. Many view cost, as stated in IAS 27.38, as being an exchange value.

7. Upon transition to IFRS a parent would be required to restate the cost of its investment in a subsidiary to ensure compliance with IAS 27. This would involve identifying the fair value of the investment at the date the subsidiary was acquired and then adjusting for any dividends that had been received from pre-acquisition retained earnings. Measuring this initial value is difficult when the fair value of the initial consideration has not been recorded and the consideration given was shares in an unlisted company for which no historical market value data exists. In this context the company would be required to revisit the initial acquisition and reconstruct the fair value to determine the cost of the acquisition.

Dividend receipts from a subsidiary paid subsequent to acquisition

8. Once a parent has established the initial cost of its investment in a subsidiary, it must then evaluate retained earnings to determine whether any dividend receipts from that subsidiary were paid, subsequent to its acquisition, out of pre-acquisition or post-acquisition retained earnings. This requirement is the cost method and it is defined in paragraph 4 of IAS 27 as:

...a method of accounting for an investment whereby the investment is recognised at cost. The investor recognises income from the investment only to the extent that the investor receives distributions from retained earnings of the investee arising after the date of acquisition. Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction of the cost of the investment.

9. As a consequence, IAS 27 requires distributions received in excess of retained earnings arising before the date of acquisition (referred to as dividends out of *pre-acquisition* retained earnings) to be regarded as a recovery of the investment and therefore accounted for as a reduction of the cost of the investment. This requirement is at the heart of two difficulties.
10. First, even if the parent is able to identify the cost of the original investment in the subsidiary, the parent is required to assess dividends after the subsidiary was acquired to determine if they are in excess of retained earnings after the date of acquisition. Restating the pre-acquisition retained earnings would be a task tantamount to restating the business combination (for which IFRS 1 provides an exemption in paragraph 15 and Appendix B). It might involve subjective, and potentially selective, use of hindsight, which would diminish the relevance and reliability of the information. In many circumstances, the restatement would be time consuming and difficult. In some circumstances it would be impossible (because it would involve making judgements about the fair values of the assets and liabilities of a subsidiary at the acquisition date).
11. Second, having established a deemed cost at the date of transition, it is not always appropriate to require a parent to adjust that deemed cost down if a dividend exceeds retained earnings after the date of transition. In most cases that dividend is not a recovery of the investment. For that reason constituents requested a concession that deemed the dividends to be from post-acquisition retained earnings.

Decisions leading to the January 2007 exposure draft

12. The Board began the deliberation phase of this project in May 2006. The Board's decisions arising from its deliberations are summarised below and are grouped as follows:

- [Deemed cost](#)

- [Dividend receipts from a subsidiary](#)

Deemed cost

13. At the September 2006 meeting, the Board decided to allow a deemed cost in the separate financial statements of first-time adopters for the purpose of determining cost in accordance with IAS 27.38(a). The deemed cost could be either:
- the parent's interest in the carrying amount of the subsidiary's assets less liabilities, using the carrying amounts that IFRSs would require in the subsidiary's statement of financial position; or
 - the fair value of the investment in the subsidiary (determined in accordance with IAS 39).

Dividend receipts from a subsidiary

14. At the September 2006 meeting, the Board proposed to provide an exemption on transition to IFRSs from restating the retained earnings of the subsidiary at the date of acquisition for the purpose of applying the cost method. The form of the exemption depended on whether the parent used the deemed cost option described in paragraph 12.
- If the parent used the deemed cost option, the Board proposed that the retained earnings of that subsidiary at the parent's date of transition should be deemed to be the pre-acquisition retained earnings for the purpose of applying the cost method in IAS 27.
 - If the parent did not use the deemed cost option, the Board proposed that the parent could determine the pre-acquisition retained earnings in accordance with the previous GAAP carrying amount for the purpose of applying the cost method.

Exposure Draft

15. In January 2007 the Board published *Cost of an Investment in a Subsidiary*, an exposure draft of proposed amendments to IFRS 1. [Click here](#) for a copy of the exposure draft.
16. The comment period for the exposure draft ended on 27 April 2007. [Click here](#) to view copies of the original comment letters received.
17. Comments from the exposure draft were presented to the Board in June 2007. [Click here](#) to view the comment letter summary analysis.

Decisions leading to the December 2007 exposure draft

18. The Board began the redeliberation phase of this project in June 2007. The Board's decisions arising from its redeliberations are summarised below and are grouped as follows:
- (a) Proposed amendments to [IFRS 1](#) *First-time Adoption of International Financial Reporting Standards*.
- [Deemed cost](#)
 - [Change in scope](#)
- (b) Proposed amendments to [IAS 27](#) *Consolidated and Separate Financial Statements*.

- [Removal of the 'cost method'](#)
- [Formation of a new parent](#)

Proposed amendments to IFRS 1

Deemed cost

19. The majority of respondents to the exposure draft were not in favour of the deemed cost exemption proposed in the exposure draft. At issue was the fact that the net asset deemed cost option described in the exposure draft does not allow for the inclusion of goodwill in the carrying amount of the net assets of the subsidiary; to do so would be tantamount to recognising internally generated goodwill. The challenge for constituents is that many would be required to write down their investment in subsidiaries on transition to IFRSs. These respondents asserted that this may present such an adverse taxation and/or legal scenario—particularly in its effect on profits available for dividend distributions—that many entities will continue to opt-out of adopting IFRSs for their separate financial statements.
20. At the September 2007 meeting, the Board redeliberated the proposed deemed cost exemption in the January 2007 exposure draft. The Board noted that it made little sense to issue the exemption proposed in the exposure draft if the constituency for which it was intended declined to use it. On the basis of respondents' comments, the Board decided that if a net asset value was used as a deemed cost, the net asset value should use the amounts that the parent incorporates in its consolidated financial statements, rather than the amounts recognised in the separate or individual financial statements of the subsidiary (as was originally proposed in the January 2007 exposure draft).
21. It was not clear to the Board, however, that this approach would address the concerns expressed by respondents. Accordingly, the Board tentatively decided that, unless it was clear that a net asset approach sufficiently reduced the cost of adopting IFRSs in the separate financial statements of parent entities, deemed cost could be measured as the carrying amount of the investment under previous national GAAP. The Board asked the staff to consult with the respondents to the exposure draft to determine whether a revised approach to calculating net assets would resolve their concerns.
22. The staff contacted the respondents to the January 2007 exposure draft and asked whether a net asset approach based on the amounts that the parent incorporates in its consolidated financial statements would be an optimal deemed cost option. Informal feedback from these respondents indicated practical difficulties still existed regardless of whether the net asset value deemed cost was based on the amounts that the parent incorporates in its consolidated financial statements or the amounts recognised in the separate or individual financial statements of the subsidiary. As a result, the staff determined that one of the deemed cost options would be to measure the amount of the investment as the carrying amount determined in accordance with previous national GAAP.
23. When determining cost in accordance with IAS 27, a first-time adopter may elect to use a deemed cost in its separate financial statements to measure some or all of its investments in subsidiaries, jointly controlled entities and associates. The proposed deemed cost shall be either:
 - (a) the fair value (determined in accordance with IAS 39) of the subsidiary, jointly controlled entity or associate at the entity's date of transition to IFRSs in its separate financial statements; or

- (b) the previous GAAP carrying amount of the subsidiary, jointly controlled entity or associate at the entity's date of transition to IFRSs in its separate financial statements.

A first-time adopter may choose which measurement to use for each individual investment in a subsidiary, jointly controlled entity or associate.

Change in scope

- 24. The Board also agreed with respondents that similar issues arise in practice in relation to determining the initial cost of an investment in jointly controlled entities and associates. Both IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* refer to IAS 27 in their description of the requirements for accounting in the investor's separate financial statements.
- 25. At the September 2007 meeting, the Board tentatively decided to extend the deemed cost exemption to the initial measurement of investments in associates and interests in joint ventures.

Proposed amendments to IAS 27

Removal of the 'cost method'

- 26. At the September 2007 meeting, the Board redeliberated its proposals regarding a simplified approach to determining the pre-acquisition retained earnings of a subsidiary for the purpose of applying the cost method in IAS 27. Even though the Board had made concessions in the January 2007 exposure draft to the basis of valuing subsidiaries and the identification of distributions from pre-acquisition profits, many respondents indicated that the remaining restrictions in IAS 27 as to how pre-acquisition profits are determined discourage companies from making the transition to IFRS, thereby stripping the exemption proposed in the exposure draft of any real value. These respondents suggested that IAS 27 be amended to permit dividends from subsidiaries to be treated as investment income, subject to an impairment test of the value of the subsidiary in the parent's accounts and consideration of whether the dividend is, in substance, a return of capital invested.
- 27. In the light of respondents' comments, the Board opted to address the requirement to assess retained earnings into pre-acquisition and post-acquisition components at a global level, rather than merely providing exemption upon first-time adoption of IFRSs in the separate financial statements of the parent entity. The Board observed that the principle underpinning the cost method is that a return of an investment should be deducted from the carrying amount of the investment. However, the current wording in IAS 27 creates a problem in some jurisdictions because it makes specific reference to retained earnings as the means of making that assessment. The Board determined that the best way to resolve this issue is to delete the definition of the cost method. The Board noted that removing the cost method also avoids the need to have an exception for investments in subsidiaries that are measured at deemed cost at the date of transition.
- 28. To reduce the risk that removing the definition of the 'cost method' would lead to investments in subsidiaries, jointly controlled entities and associates being systematically overstated, the Board proposed that any dividend received by an investor from its investment in a subsidiary, jointly controlled entity or associate be recognised as income and the related investment be tested for impairment in accordance with IAS 36 *Impairment of Assets*. Investments in a subsidiary, jointly controlled entity or associate are already within the scope of IAS 36.

Formation of a new parent

29. At the July 2007 meeting, the Board considered how paragraph 38 of IAS 27 applied to the formation of a new parent entity for an existing group when there are no changes in substance resulting from the revised organisation structure.
30. The Board observed that the formation of a new parent is unique in several respects. First, it does not involve a transfer of resources outside of the group. The equity, assets and liabilities of the group do not change as a result of the reorganisation. In addition, the relative ownership interests of the owners of the existing entity do not change. Finally, this type of reorganisation involves an existing entity and its shareholders agreeing to create a new parent between them. In contrast, most transactions or events that result in a parent–subsidiary relationship are initiated by a parent over an entity that will be positioned below it in the group. The Board tentatively decided that in such reorganizations, the new parent should measure cost for the purpose of applying paragraph 38(a) of IAS 27 by using the carrying amounts of the equity, assets and liabilities in the separate financial statements of the existing entity at the date of the formation.
31. The Board also directed the staff to consider linking this proposed amendment to IAS 27 with the active project on proposed amendments to IFRS 1. The Board observed that both projects address issues involved in determining the cost of an investment in a subsidiary. At the September 2007 meeting, the Board approved the staff recommendation to combine the two projects in the form of a second exposure draft.

Re-exposure

32. In accordance with its due process requirements, the Board published a second exposure draft: *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* on 13 December 2007. [Click here](#) for a copy of the exposure draft.
33. The second exposure draft is divided into two components:
 - (a) specific exemption for first-time adopters of IFRSs in the separate financial statements of a parent entity; and
 - (b) modifications to IAS 27 that apply to all users of IFRS, *not only* first-time adopters.
34. The comment period for the exposure draft ended on 26 February 2008. [Click here](#) to view copies of the original comment letters received.
35. Comments from the exposure draft were presented to the Board in April 2008. [Click here](#) to view the comment letter summary analysis.

Decisions leading to the final Amendments

36. The Board began the second redeliberation phase of this project in April 2008. The Board's decisions arising from its redeliberations are summarised in the **Summary of the Amendments** section of this paper.

Amendments to IFRS 1

Deemed cost

37. The majority of respondents to the December 2007 exposure draft supported the Board's proposals to allow the use of a deemed cost to account for an investment in a subsidiary, jointly controlled entity or associate. Respondents were nearly universal in indicating that the proposed amendments to IFRS 1 would reduce the time and cost involved in adopting IFRS in the separate financial statements of parent companies.

Change in scope

38. Respondents also unanimously agreed with the Board's intention to expand the use of the deemed cost option for investments in jointly controlled entities and associates in the separate financial statements of investors.

Amendments to IAS 27

Removal of the 'cost method'

39. Although the majority of respondents support the Board's proposal to delete the definition of the cost method from IAS 27, many questioned the appropriateness of the proposed accounting treatment that would replace it. Specifically, respondents were split as to whether dividend receipts should *always* be presented as income. Additionally, respondents were nearly unanimous in their rejection of the Board's proposal to require impairment testing (at the nearest reporting date) of the investment in a subsidiary, jointly controlled entity or associate when a dividend is paid to the investor.
40. At the April 2008 meeting, the Board redeliberated its proposals regarding the removal of the cost method from IAS 27. The underlying principle of the approach proposed in paragraph 37B of the ED is that dividends received from a subsidiary, jointly controlled entity or associate generate income in the separate financial statements, provided the dividend does not cause the value of the investment to fall below its carrying amount. This introduces a two step process for the recognition of dividends whereby, 1) income is recognised and 2) the related investment is tested for impairment. This principle should be applied to all distributions, regardless of their source (including capital), such that all distributions are recognised as income with an impairment test being conducted. The legal label attached to that part of equity that is distributed may differ from jurisdiction to jurisdiction however this should not affect the accounting.
41. The Board decided to retain the proposal that dividends from an investee be recognised as income in the separate financial statements of the investor. If an investor chooses to account for its investment in a subsidiary, jointly controlled entity or associate at fair value (as opposed to cost) in accordance with IAS 27.38, the investor would be required to follow the presentation requirements in IAS 39. Consequently, the dividend receipt would be recognised as income; in the event of an impairment, any cumulative loss that had been recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment even though the investment has not been derecognised. This gross approach to presentation is mirrored in the ED's proposals: dividends are recognised as income with any associated impairment presented separately. Regardless of whether an investor chooses to account for its investment in a subsidiary, jointly controlled entity or associate at cost or fair value, the presentation of the result will be the same.
42. Additionally, the Board decided to modify its impairment proposals. Instead of automatically triggering an impairment test, dividend payments from an investee to its investor trigger an impairment test when either of the following two indicators are present:
- the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee's net assets, including associated goodwill; or
 - the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared.

Formation of a new parent

43. The views of respondents to the 2007 exposure draft were mixed. Approximately half of the respondents supported the proposal (and the Board's related basis) for a new parent to measure the cost of its investment in the previous parent using a carryover basis. The other respondents suggested addressing the issue in the common control project or permitting entities to choose between a carryover basis and fair value.
44. The Board decided to retain the proposal. In response to the comments received, the Board clarified that the amendment applies to the following types of reorganisations when they satisfy the criteria specified in the amendment
- (a) reorganisations in which the new parent does not acquire all of the equity instruments of the original parent.
 - (b) the establishment of an intermediate parent within a group, as well as the establishment of a new ultimate parent of a group.
 - (c) reorganisations in which an entity that is not a parent establishes a new entity as its parent.

Contact information

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