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Relief proposed for measuring investments in subsidiaries on first-time adoption

On 25 January 2007, the International Accounting Standards Board (IASB) published an Exposure Draft (ED) which would amend IFRS 1 **First-time Adoption of International Financial Reporting Standards**. The proposals respond to concerns about difficulties encountered by parent entities in measuring the cost of investments in subsidiaries when adopting International Financial Reporting Standards (IFRSs) for the first time.

The IASB has requested comments on the proposals by 27 April 2007.

Measurement of investments in subsidiaries

IAS 27 **Consolidated and Separate Financial Statements** requires a parent, in its separate financial statements, to account for an investment in a subsidiary either at cost or at fair value in accordance with IAS 39 **Financial Instruments: Recognition and Measurement**. This requirement presents a problem for some parent entities when IFRSs are adopted for the first time, in circumstances where the parent is unable to determine cost in accordance with IFRSs and is deterred from using fair value to account for the investment by the need to remeasure the investment at fair value at each subsequent reporting date.

The ED proposes to allow a parent, at its date of transition to IFRSs, to use a 'deemed cost' to measure its investments in subsidiaries. This deemed cost would be determined as 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 balance sheet; or
- the fair value of the investment in the subsidiary.

First-time adopters would be permitted to choose which measurement to use for each investment on an individual basis – therefore some investments could be measured in accordance with the general rules of IAS 27, and some at deemed cost; and, for those measured at deemed cost, the choice between the carrying amount of the net assets of the subsidiary, and its fair value, would be made on an individual investment basis.

Determining the pre-acquisition accumulated profits of a subsidiary

IAS 27 also requires a parent to recognise distributions received from the pre-acquisition accumulated profits of a subsidiary as a reduction in the cost of the investment. If the parent acquired a subsidiary before the parent's date of transition to IFRSs, the parent might need to know the subsidiary's pre-acquisition accumulated profits under IFRSs in order to determine the appropriate accounting for a subsequent dividend.

IFRS 1 exempts entities from restating business combinations prior to the date of transition to IFRSs because of the numerous practical difficulties involved, and it would therefore be unfortunate if the entity were required to restate the business combination simply to arrive at an amount for pre-acquisition profits in order to meet the IAS 27 requirements.

The Board therefore proposes to provide an exception on transition to IFRSs from restating the accumulated profits of the subsidiary at the date of acquisition. The form of the exception depends on whether the parent uses the proposed exemption from restating the cost of the investment on first-time adoption (as discussed in the previous section).

Therefore, for the purpose of applying the cost method in IAS 27, the ED proposes that:

(a) when a parent measures an investment in a subsidiary using a deemed cost in accordance with the ED, the parent shall, at the date of transition to IFRSs, treat that subsidiary's accumulated profits under IFRSs as pre-acquisition accumulated profits; and

(b) a parent shall, for subsidiaries that have not been measured at deemed cost, either:

(i) determine the pre-acquisition accumulated profits of each subsidiary under IFRSs; or

(ii) treat the pre-acquisition accumulated profits of each subsidiary under previous GAAP as the pre-acquisition accumulated profits under IFRSs.

These proposals are illustrated in the following example, which has been repeated from the ED for users' convenience.

Parent X's date of transition to IFRSs is 1 January 2007. Parent X has two subsidiaries, Subsidiary Y and Subsidiary Z. All entities use the same GAAP before Parent X's transition to IFRSs.

On 1 January 2007:

(a) Parent X elects to use the cost method in IAS 27 for the subsidiaries in its separate financial statements;

(b) for Subsidiary Y only, Parent X uses a deemed cost to measure the cost of the investment;

(c) under its previous GAAP, Subsidiary Y has pre-acquisition accumulated profits of 350 and total accumulated profits of 800;

(d) under its previous GAAP, Subsidiary Z has pre-acquisition accumulated profits of 300 and total accumulated profits of 900;

(e) there are IFRS transition adjustments in Subsidiary Y and Subsidiary Z that would change their accumulated profits at the acquisition date;

(f) in accordance with IFRSs, the accumulated profits of Subsidiary Y and Subsidiary Z are 650 and 1,000 respectively.

Some time after the date of transition to IFRSs, Subsidiary Y and Subsidiary Z pay a dividend to Parent X equal to their entire accumulated profits calculated in accordance with IFRSs. Their accumulated profits at this time were 750 and 950 respectively.

Subsidiary Y: On transition to IFRSs, Parent X elects to use a deemed cost for its investment in Subsidiary Y only. At Parent X's date of transition to IFRSs the accumulated profits of Subsidiary Y under IFRSs are 650. Therefore, 650 is Subsidiary Y's pre-acquisition accumulated profits for the purpose of applying the cost method in IAS 27 and Parent X treats 650 of the dividend from Subsidiary Y as a reduction in the cost of its investment in Subsidiary Y. Parent X recognises the remainder of the dividend (100) as revenue.

Subsidiary Z: Parent X elects to use Subsidiary Z's pre-acquisition accumulated profits arising under its previous GAAP for the purpose of applying the cost method in IAS 27. Therefore, Parent X treats the portion of the dividend that relates to the pre-acquisition accumulated profits of Subsidiary Z under its previous GAAP as a return on the investment in Subsidiary Z (300). Parent X recognises the remainder of the dividend (650) as revenue.

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