IFRS hot topic...

... cost of an investment in a subsidiary in separate financial statements

IFRS hot topic 2009-01

Issue
This hot topic provides guidance on the following issues when measuring investments in subsidiaries at cost in separate financial statements (SFS) in accordance with IAS 27:
• contingent consideration arrangements
• previously-held interests at the date of obtaining control
• acquisition-related costs. These issues arise in part because of the changes to IAS 27 eliminating the definition of the cost method, and the introduction in IFRS 3 (2008) of the rules for determining consideration transferred (see boxed text below).

Does IFRS 3 (2008) change IAS 27 requirements on cost in SFS?

The January 2008 version of IFRS 3 changes the treatment of these three items in business combination accounting (along with many other changes – see IFRS Alert 2008-01 for a summary). Important changes were also made to IAS 27, although those changes did not affect SFS: IFRS 3 (2008) does not apply to the measurement of investments in subsidiaries in SFS. Moreover the new IFRS 3 no longer refers to the ‘cost of a business combination’ but instead uses the term ‘consideration transferred’ - a different concept. Despite the absence of an explicit link, some of the IFRS 3 (2008) changes have led to questions over how to measure the cost of an investment in a subsidiary in accordance with IAS 27. This hot topic sets out Grant Thornton International’s view on the most frequently asked questions.

This hot topic discusses the accounting for these items in SFS and makes comparisons with the treatment in business combination accounting. It should however be noted that a business combination does not always involve obtaining control over a subsidiary (e.g. a so-called trade and asset purchase might be a business combination). Moreover, obtaining control over a subsidiary gives rise to a business combination only if the subsidiary is or contains a business as defined in IFRS 3 (2008).

Guidance

Cost and IAS 27
IAS 27 permits a parent to measure investments in subsidiaries in its SFS either at cost or at fair value under IAS 39 (IAS 27.38). This Hot Topic only considers the cost model, which is more commonly applied. The IFRS Glossary defines cost as: ‘the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction; or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRSs, eg IFRS 2’. Neither this definition nor IAS 27 provide specific guidance on the issues addressed in this hot topic.

As a result of amendments in May 2008, IAS 27 no longer refers to the ‘cost method’ (under which distributions paid out of pre-acquisition profits were treated as a reduction of the cost of the investment). Accordingly, cost in IAS 27 now has its normal meaning as per the definition quoted above. The May 2008 change is effective prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted.
Contingent consideration arrangements

In purchasing an investment in a subsidiary, a parent entity might agree to transfer additional assets or equity interests to the vendor if specified future events occur or conditions are met (or the parent might have the right to the return of amounts paid under specified conditions). These arrangements are referred to as contingent consideration in IFRS 3 (2008).

IFRS 3 addresses the treatment of contingent consideration in the context of business combination accounting. There is no explicit guidance on its treatment in measuring cost in SFS. In our view:

• At the date of obtaining control the parent should include the fair value of a contingent consideration obligation (or right) as part of the cost of its investment in a subsidiary, consistent with the IFRS 3 (2008) treatment in business combination accounting. We believe that this is consistent with the definition of cost and also reflects the fact that the contingent consideration contract will need to be included as an asset, liability or equity item in accordance with IAS 32 or IAS 39 if applicable (in both the consolidated financial statements and in the SFS).

• When the fair value of a contingent consideration contract within the scope of IAS 39 changes, our preferred view is that gains and losses are recorded in profit or loss in the SFS consistent with the approach required by IFRS 3 (2008). An alternative view is that gains or losses are treated as adjustment to the cost of investment such that the 'final' cost amount will equal the cash paid. Support for this alternative view can be drawn by analogy with the treatment of changes in a decommissioning liability that is included as part of the cost of a related asset (see IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities). We believe that current practice (before consideration of the requirements of IFRS 3 (2008) or the changes to IAS 32 and IAS 39) is to include contingent consideration as part of cost in SFS either as payments (eg of cash or shares) are made, or when they fall to be recognised as a liability under the previous version of IFRS 3. The previous version of IFRS 3 requires contingent consideration (referred to as an adjustment to the cost of the combination) to be recognised when it becomes probable and is reliably measurable. Accordingly, adoption of either of the approaches above will be a change of accounting policy in many cases (see later guidance on applying a change of accounting policy).
Previously-held interests at the date of obtaining control

Prior to obtaining control over an entity, a parent/investor might have held an existing (non-controlling) investment in that entity. Such an investment might have been an associate, interest in a jointly controlled entity (noting that such investments are measured at cost or in accordance with IAS 39 in SFS), or a financial asset within the scope of IAS 39. A financial asset within the scope of IAS 39 might be classified (i) as held for trading and measured at fair value through profit or loss; or (ii) as available for sale and measured at fair value with gains/losses (except impairment losses) recorded in other comprehensive income (OCI); or (iii) at cost less impairment if fair value is not reliably measurable.

There is no explicit guidance on how to treat previously-held interests in measuring cost in SFS. In our view, IFRS 3 (2008)'s characterisation of a previously-held interest as part of what is exchanged for control of the acquiree can be extended to the measurement of cost of an investment for IAS 27 purposes. However, a more traditional view of cost as the total of the costs at each stage of the purchase is also acceptable (noting that cost in IAS 27 and consideration transferred in IFRS 3 are different concepts).

Accordingly, we believe that the parent has an accounting policy choice in its SFS to:

- Apply the IFRS 3 (2008) approach (see text box above and example below); or
- Treat the total cost of the investment as the cost incurred to acquire the previous investment plus the cost of the interest that confers control. Under this approach:
  - If the previous investment has been measured at cost (less impairment), the cost of the controlling interest is simply added to the carrying value of the previous (non-controlling) interest. We believe that any past impairment loss recognised should be viewed as establishing a new cost basis and should not therefore be reversed.
  - If the previous investment has been measured at fair value (as a held for trading or available for sale financial asset), gains and losses recognised prior to obtaining control would need to be reversed in order to restate the investment to cost. We believe this restatement should be effected by adjusting the appropriate component of equity (ie the component that includes the previous gain or loss (typically retained earnings in the case of a held for trading investment, or an AFS reserve in the case of an available for sale financial asset). We do not believe the restatement to cost results in gains or losses in profit or loss or OCI under this approach because it is not a gain or loss as defined in the Framework.
Example - Previously-held available for sale investment in the SFS

Entity P is a parent entity and prepares both consolidated and separate financial statements. At 31.03.X0 it holds a 10% equity interest in Entity S, which is classified as an available for sale financial asset. The original cost of the investment was CU50. At 31.03.X0 the fair value and carrying value is CU70. The cumulative gain of CU20 has been recognised in OCI and is included in a separate AFS reserve in Entity P's consolidated and separate financial statements.

At 01.04.X0 Entity P acquires the other 90% of Entity S for cash consideration of CU600, with Entity S becoming a subsidiary at that date. Acquisition-related costs are not significant. Entity P's accounting policy for investments in its subsidiaries in the separate financial statements is to use cost. How is the previous investment treated in applying this policy?

Option 1 - apply IFRS 3 approach

The fair value of the previous investment (CU70) is included as part of the cost of the total interest in Entity S, which is therefore CU700 (CU70 + CU630). The cumulative gain previously recognised within OCI is reclassified into profit and loss. The required journal entry is as follows:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of investment in subsidiary</td>
<td>700</td>
</tr>
<tr>
<td>AFS investment</td>
<td>70</td>
</tr>
<tr>
<td>Cash</td>
<td>630</td>
</tr>
<tr>
<td>AFS reserve (equity)</td>
<td>20</td>
</tr>
<tr>
<td>Gain on disposal of AFS (P&amp;L)</td>
<td>20</td>
</tr>
</tbody>
</table>

Option 2 - treat cost as the cost of each stage

The original cost of the previous investment (CU50) is included as part of the cost of the total interest in Entity S, which is therefore CU650 (CU50 + CU600). The cumulative gain of CU20 previously recognised within OCI and included in the carrying amount of the AFS asset is reversed against the AFS reserve within equity. There is no effect on profit & loss or OCI for the period. The required journal entry is as follows:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of investment in subsidiary</td>
<td>650</td>
</tr>
<tr>
<td>AFS investment</td>
<td>70</td>
</tr>
<tr>
<td>Cash</td>
<td>630</td>
</tr>
<tr>
<td>AFS reserve (equity)</td>
<td>20</td>
</tr>
</tbody>
</table>

Note - if the previous investment has been classified as held for trading the Option 1 approach would simply involve adding the cost of the new 90% interest to the fair value of the previous 10% interest. There would be no effect on profit or loss at the date of acquiring the 90% interest. Under the Option 2 approach, the accounting would be similar to the above journal entry but the previous fair value movement (which would have been reported in profit or loss) would be eliminated against retained earnings.
Acquisition-related costs

Acquisition-related costs in a business combination
IFRS 3 (2008) requires that acquisition-related costs are accounted for as an expense when incurred or when services are rendered (other than costs to issue debt or equity securities, which are accounted for in accordance with IAS 32 or IAS 39 as applicable). This is a change from the previous version of IFRS 3, which required costs directly attributable to a business combination to be included in the cost of the combination.

In obtaining control over a subsidiary, a parent entity might incur various expenses in addition to amounts payable to the vendor, such as legal, accounting and consulting fees. IFRS 3 (2008) is clear that such costs are expensed and are not part of the consideration transferred in exchange for the acquiree (IFRS 3.53). However, in our view it is probably not appropriate to draw an analogy with IFRS 3 (2008) in this area. The Basis for Conclusions to IFRS 3 (2008) explains that the treatment of acquisition-related costs is a consequence of the change to a concept of consideration transferred by the acquirer to the vendor in exchange for the acquiree (IFRS 3 (2008).BC365-370). We believe that 'cost' in IAS 27 is not the same as 'consideration transferred'. The possible differences in the treatment of costs are mentioned in IFRS 3 (2008).BC369 which states:

"... the boards accept that, at this time, accounting for most acquisition-related costs separately from the business combination, generally as an expense as incurred for services received in connection with a combination, differs from some standards or accepted practices that require or permit particular acquisition-related costs to be included in the cost of an asset acquisition..."

IAS 27 does not provide any guidance on acquisition-related costs, and practices may differ. However, our preferred view is to include directly attributable costs in the cost of investment. This approach is also consistent with the treatment of directly attributable transaction costs incurred in relation to investments measured at cost or amortised cost under IAS 39 (IAS 39.43). Judgement may be required in some cases to determine which costs are 'directly attributable', but providing detailed guidance on this matter is beyond the scope of this hot topic.

Applying a change of accounting policy - retrospective or prospective?
Application of the guidance provided above might involve a change of accounting policy in particular to:

• include the acquisition-date fair value of contingent consideration contracts within the cost of an investment in a subsidiary for the purpose of the SFS; and/or

• apply an IFRS 3 (2008) type approach for previously-held investments in the SFS.

In our view the inclusion of contingent consideration is effectively mandated by the changes to the scope of IAS 32 and IAS 39, which take effect for years beginning on or after 1 July 2009. In other words, this is not a voluntary change of accounting policy. The IAS 32 and 39 changes are not stated to be prospective. However, the changes are consequential to IFRS 3 (2008), which is applied prospectively. The effective date paragraphs of IAS 32 and IAS 39 also refer to IFRS 3 (2008) (IAS 32.97B and IAS 39.103D). Accordingly, we believe that the related change of accounting policy in the SFS should be applied prospectively as well, based on IAS 8.19(a). Under this approach, the cost of investments in subsidiaries acquired in annual periods that commenced before 1 July 2009, and for which part of the cost was contingent consideration, is not adjusted.

We believe that a change of accounting policy for previously-held investments in the SFS (to adopt an IFRS 3 (2008) type approach) should also be applied prospectively. This is only the case if the
change of accounting policy is made as part of the overall adoption of IFRS 3 (2008) and the related
to IAS 27. Such a policy is based on an analogy with the related requirements of IFRS 3
(2008) and the concepts underlying those requirements. We therefore believe the prospective
application approach of IFRS 3 (2008) can also be extended to the SFS in this area.

It should however be noted that the transition requirements are open to interpretation, particularly in
relation to the second issue. An alternative view is that changing the policy for previous interests in
determining costs is a voluntary change of accounting policy. Voluntary changes of accounting policy
are accounted for retrospectively subject to an impracticability constraint (IAS 8.19(b) and 23).

Further Information
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