Amendments to IFRS 1, First Time Adoption of International Financial Reporting Standards, Cost of an Investment in a Subsidiary

This Comment Letter was sent by BDO Global Coordination B.V. on behalf of BDO International, to the International Accounting Standards Board on 24 May, 2007:

Dear Mr Singleton,

Exposure Draft of Proposed
Amendments to IFRS 1 *First Time Adoption of International Financial Reporting Standards*
Cost of an investment in a subsidiary

We welcome the opportunity to comment on the above exposure draft and also the Board's willingness to address an issue which is of particular concern in a number of jurisdictions. Please accept our apologies for the late submission of our response, on behalf of BDO International[1].

General comments

Net assets deemed cost option

We welcome the fact that the Board is suggesting a pragmatic approach to addressing the problem of calculating the 'cost' of investments in subsidiaries on first time adoption. Many companies that have adopted IFRS in their consolidated accounts have not restated their individual accounts under IFRS, with some having been deterred by the accounting requirements for subsidiaries, and for dividends received from them (see comment below in respect of the accounting treatment of dividends). The ability to use a deemed cost may mean that fewer companies are deterred from restating their individual accounts under IFRS as, without it, companies would have to apply the requirements in IAS 27 *Consolidated and Separate Financial Statements* fully retrospectively in order to derive a cost figure. This can be costly in terms of both time and money. However, for the reasons given in our response to question one, we do not think that the proposed approach to deemed cost is the best answer. Instead, our preference is for a simple exemption based on the previous GAAP carrying amount. We would support such an approach whether this is a revalued amount or an amount stated after any available local reliefs such as merger relief (where the carrying amount of a subsidiary acquired by way of a share for share exchange may be recorded at the nominal value only of the shares issued by the parent). Many individual companies have chosen not to adopt IFRS for their individual company accounts as they cannot grandfather the local GAAP carrying amount in respect of subsidiaries, associates and joint ventures.

Nevertheless, we also welcome the additional option to use fair value to determine deemed cost without the need for subsequent annual revaluations and the opportunity for a first-time adopter to choose which transitional measurement basis to use for each individual investment in a subsidiary.

Accounting treatment of dividends received from subsidiaries

We strongly suggest that IAS 27 is 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.

Associates and jointly controlled entities

The Exposure Draft specifically applies to subsidiaries but we note that similar issues can arise in relation to associates and jointly controlled entities. IAS 28 and IAS 31 both refer to IAS 27 when stating the requirements for accounting in the investor's separate financial statements. Therefore, any exemption from IAS 27(37) should apply equally to investments in associates and jointly controlled entities and this should be explicitly stated in the revised IAS 27.

Illustrative guidance

We believe that IG Example 9B might be more helpful if it illustrated a vertical rather than a horizontal group. It would also be helpful if the example were specifically to confirm that it is not necessary to perform a sub-consolidation at each level of a vertical group and that an aggregation of the separate financial statements net assets of the subsidiaries is all that is required. Other approaches can be impracticable for many groups.

Responses to IASB questions

Our comments on the specific questions raised in the invitation to comment are set out below.

Question 1

IAS 27 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). However, the Board believes that in some cases, on first-time adoption of IFRSs, the difficulties in determining cost in accordance with IAS 27 exceed the benefit to users.

This Exposure Draft proposes to allow a parent, at its date of transition to IFRSs, to use a deemed cost for an investment in a subsidiary. The deemed cost would be determined using either the carrying amount of the net assets of the subsidiary, or its fair value, at that date. Is this appropriate? If not, why?

We welcome the ability for a parent to use a 'deemed cost' for an investment in a subsidiary on its transition to IFRS based on its net assets as restated under IFRS. Requiring cost to be calculated in accordance with IAS 27 on a fully retrospective basis could, in some cases, cause significant difficulties, for example where merger relief (where the carrying amount of a subsidiary acquired by way of a share for share exchange may be recorded at the nominal value only of the shares issued by the parent) was taken in the past. The information required for measuring the cost in accordance with the existing IAS 27 might be unavailable or difficult to obtain.

However we doubt whether it is obvious how to measure the carrying amount of the net assets of the subsidiary. Should such a carrying amount be based on:

the financial statements of the subsidiary based on its own IFRS 1 transitioning, or

the group reporting IFRS 1 transitioning schedules as part of the reporting entity?

In addition, we do not consider that the proposed 'deemed cost' as at the date of transition gives the most appropriate accounting answer. It is also not entirely clear as to whether the reference to assets and liabilities in the subsidiary's balance sheet relates to those of the individual subsidiary or whether paragraph B5(b) is referring to the assets and liabilities of a sub group where the subsidiary is itself an intermediate holding company.

Given that many companies have not restated their individual accounts under IFRS, as noted above our preference would be for a simple exemption based on the previous GAAP carrying amount. We would support this, whether this is a revalued amount or an amount stated after any available local reliefs.

We accept that our suggested approach may mean that the deemed cost varies considerably from what would otherwise be required under IAS 27. Nevertheless, this deviation is consistent with other exemptions available in IFRS 1. For instance, goodwill may bear no relation to the amount that would have been recognised had IFRS 3 been applied, particularly if merger accounting had been justifiably used under previous GAAP. In addition, paragraph B6(b)(ii) allows the possibility of treating the pre-acquisition accumulated profits of each subsidiary under previous GAAP as the pre-acquisition accumulated profits under IFRSs.

On the grounds of consistency with IAS 39, we welcome the option to use the fair value of the investment of the subsidiary as at the date of transition to determine deemed cost. For practical reasons, we also support the ability not to carry out subsequent annual revaluations as well as the availability of the opportunity for a first-time adopter to choose which transitional measurement basis to use for each individual investment in a subsidiary.

Question 2

The cost method in IAS 27 requires a parent to recognise distributions from a subsidiary as a reduction in the cost of the investment to the extent they are received from the subsidiary's pre-acquisition profits. This may require a parent, in some cases, to restate the subsidiary's pre-acquisition accumulated profits in accordance with IFRSs.

Such a restatement would be tantamount to restating the original business combination, requiring judgements by management about past conditions after the outcome of the transaction is known.

This Exposure Draft proposes a simplified approach to determining the pre-acquisition accumulated profits of a subsidiary for the purpose of the cost method in IAS 27. Is this appropriate? If not, why?

We agree that it is appropriate to allow a simplified approach to determining the pre-acquisition accumulated profits of a subsidiary. Requiring all subsidiary companies that are not currently preparing their accounts under IFRS to restate their accumulated profits as at the date of transition under IFRS would often be an onerous task.

However, where the net asset deemed cost approach is taken, we suggest that a parent should treat the subsidiary's accumulated profits under IFRS as pre-acquisition profits only to the extent that the deemed cost is higher than the previous GAAP investment carrying amount. This is to avoid a 'double charge' which otherwise could arise which is illustrated by the following example.

Consider a company with an investment in a subsidiary recorded under previous GAAP at £10m. The subsidiary has £2m of post acquisition profits which could be distributed to the parent and treated as income in the parent's financial statements were it not for the use of the deemed cost exemption. The IFRS net asset value of the subsidiary per the subsidiary's balance sheet is (say) £5m (being £3m at the date of acquisition together with the £2m of post acquisition profits). If the parent elects to use the IFRS net asset value as deemed cost exemption it will recognise a loss on transition of £5m. Under the approach set out in B6(a) it would appear that it would be required to treat the distribution of any part of the £2m as a reduction in the cost of investment rather than as income.

We hope that our comments and suggestions are helpful. Should you wish to discuss them further, please contact Helen Thomson of BDO Global Coordination B.V. on +32 2 778 01 30.

Yours sincerely,

BDO Global Coordination B.V.

[1]BDO International is a world wide network of public accounting firms, called BDO Member Firms, serving international clients. Each BDO Member Firm is an independent legal entity in its own country.

The network is coordinated by BDO Global Coordination B.V., incorporated in the Netherlands, with an office in Brussels, Belgium, where the Global Coordination Office is located.