

Technical Accounting Alert

Cost of an investment in a subsidiary in separate financial statements

Introduction

The purpose of this alert is to provide 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; and
- 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).

Relevant Australian standards

References in this TA alert are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IFRS <i>Glossary</i>	AASB <i>Glossary</i>
IFRS 3 <i>Business Combinations</i>	AASB 3 <i>Business Combinations</i>
IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>	AASB 108 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>
IAS 27 <i>Consolidated Financial Statements</i>	AASB 127 <i>Consolidated Financial Statements</i>
IAS 32 <i>Financial Instruments: Presentation</i>	AASB 132 <i>Financial Instruments: Presentation</i>
IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>	AASB 137 <i>Provisions, Contingent Liabilities and Contingent Assets</i>
IAS 39 <i>Financial Instruments: Recognition and Measurement</i>	AASB 139 <i>Financial Instruments: Recognition and Measurement</i>
IFRIC 1 <i>Changes in Existing Decommissioning, Restoration and Similar Liabilities</i>	Interpretation 1 <i>Changes in Existing Decommissioning, Restoration and Similar Liabilities</i>

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Overview

This alert 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 (eg 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).

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

IFRS 3 changes the treatment of these three items in business combination accounting (along with many other changes - see TA Alert 2008-12 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 alert is Grant Thornton's view on the most frequently asked questions.

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 alert 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 provides specific guidance on the issues addressed in this alert.

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.

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).

Contingent consideration in a business combination

In summary, IFRS 3 (2008)'s requirements on contingent consideration are as follows:

- a) contingent consideration is included in the consideration transferred at fair value at the acquisition date (unless it represents something other than consideration transferred for the acquiree) (IFRS 3.37 and 39);
- b) the obligation to pay contingent consideration is recorded as a financial liability or equity item in accordance with definitions in IAS 32 or other applicable IFRSs (IFRS 3.40); and
- c) after the acquisition date a recognised financial asset or liability for contingent consideration is measured at fair value with gains or losses recognised in profit or loss. Contingent consideration classified as equity is

not remeasured (IFRS 3.58)*.

An acquirer's contingent consideration contract is no longer scoped out of IAS 32 and IAS 39. Such a contract is therefore accounted for in accordance with those Standards where applicable. The previous scope exemptions, which were in IAS 32.4(c) and IAS 39.2(f), have been deleted.

* IFRS 3.58(b)(ii) also refers to a contingent consideration asset or liability within the scope of IAS 37 or another IFRS. In practice we believe that most arrangements will be within the scope of IAS 32 or IAS 39, and that IAS 37 will apply only rarely.

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 Grant Thornton's 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, Grant Thornton's 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 previous 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 fail 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.

Previously-held interests in a business combination

IFRS 3 (2008) changes the accounting for business combinations achieved in stages (step acquisitions). The new requirements reflect a view that, in effect, the previously held investment asset is part of what is exchanged for a controlling interest in all of the acquiree's underlying assets and liabilities (IFRS 3.BC384). As a result, IFRS 3 requires that:

- the fair value of the previous interest is included in the determination of goodwill (IFRS 3.32);
- the remeasurement of that interest to its fair value (eg if it was measured at cost) is recognised in profit or loss; and
- the amounts recognised in OCI (eg in relation to an available for sale financial asset) are reclassified to the income statement as if the investment had been disposed of (IFRS 3.42).

There is no explicit guidance on how to treat previously-held interests in measuring cost in SFS. In Grant Thornton's view, IFRS 3'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, Grant Thornton believes 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. Grant Thornton 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 \$50. At 31.03.X0 the fair value and carrying value is \$70. The cumulative gain of \$20 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 \$630, 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 (\$70) is included as part of the cost of the total interest in Entity S, which is therefore \$700 (\$70 + \$630). The cumulative gain previously recognised within OCI is reclassified into profit and loss. The required journal entry is as follows:

	Dr	Cr
Cost of investment in subsidiary	700	
AFS investment		70
Cash		630
AFS reserve (equity)	20	
Gain on disposal of AFS (P&L)		20

Option 2: Treat cost as the cost of each stage

The original cost of the previous investment (\$50) is included as part of the cost of the total interest in Entity S, which is therefore \$680 (\$50 + \$630). The cumulative gain of \$20 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:

	Dr	Cr
Cost of investment in subsidiary	680	
AFS investment		70
Cash		630
AFS reserve (equity)	20	
	Dr	Cr

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 Grant Thornton's 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). Grant Thornton 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, Grant Thornton's 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 alert.

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 Grant Thornton's 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. Accordingly, Grant Thornton 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 changes 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).

Note

On 12 November 2009, the IASB published IFRS 9 Financial Instruments (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets. The publication of IFRS 9 represents the completion of Phase 1 of IASB's project to replace IAS 39. However, at this stage IFRS 9 only addresses the classification and measurement of financial assets. Financial liabilities therefore continue to be accounted for in accordance with IAS 39. Work has begun on Phases 2 and 3 of the project which addresses impairment and hedge accounting, respectively. Also, a separate project is underway to replace IAS 39's requirements on derecognition.

IFRS 9 was issued in Australia as AASB 9 Financial Instruments with an effective date of 1 January 2013 and therefore AASB 9 requirements have not been considered for the purpose of this alert.

Further information

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