PROPOSED FINANCIAL REPORTING STANDARD	ED/FRS

Exposure Draft

Amendments to FRS 101 *First-time Adoption of Financial Reporting Standards* and FRS 27 *Consolidated and Separate Financial Statements*

Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate

Comments to be received by 4 February 2008

This exposure draft *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*, proposed amendments to FRS 101 *First-time Adoption of Financial Reporting Standards* and FRS 27 *Consolidated and Separate Financial Statements* is issued by the Accounting Standards Council (ASC) for comment only and does not necessarily represent the views of ASC.

Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, clearly explain the problem and provide a suggestion for alternative wording with supporting reasoning.

Comments should be submitted in writing, so as to be received by **4 February 2008**, preferably by email to:MOF_Feedback_ASC@mof.gov.sg or addressed to:

Accounting Standards Council
c/o Ministry of Finance
100 High Street #10-01
The Treasury
Singapore 179434

CONTENTS

INTRODUCTION AND INVITATION TO COMMENT

PROPOSED AMENDMENTS TO FRS 101

PROPOSED AMENDMENTS TO FRS 27

APPENDIX
Amendments to other FRSs

BASIS FOR CONCLUSIONS

Introduction and invitation to comment

In January 2007 the International Accounting Standards Board published *Cost of an Investment in a Subsidiary*, an exposure draft of proposed amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. The comment period ended on 27 April 2007. After considering respondents' comments, the Board revised the exemption proposed in the exposure draft. Additionally, the Board decided to modify the scope of the proposed amendments and to address an additional issue that arose during the comment period. In the light of the changes to the exemption proposed, the modified scope of the proposed amendments and the proposal of additional amendments to IAS 27 *Consolidated and Separate Financial Statements*, the Board is publishing this second exposure draft *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*.

The equivalent exposure draft had been issued in Singapore.

ASC invites comments on any aspect of this exposure draft of proposed amendments to FRS 101 and FRS 27. It particularly welcomes answers to the questions set out below. Comments are most helpful if they:

(a) answer the question as stated,

(b) indicate the specific paragraph or paragraphs to which they relate,

(c) contain a clear rationale, and

(d) describe any alternative the ASC should consider.

Respondents need not comment on all of the questions. ASC is not requesting comments on matters in FRS 101 or FRS 27 not addressed in this exposure draft.

ASC will consider all comments received in writing by 4 February 2008. In considering the comments, the ASC will base its conclusions on the merits of the arguments for or against each alternative, not on the number of responses supporting each alternative.

Question 1—Deemed cost

The exposure draft proposes to allow an entity, at its date of transition to FRSs in its separate financial statements, to use a deemed cost to account for an investment in a subsidiary, jointly controlled entity or associate. The exposure draft proposes that an entity may choose as the deemed cost of such investments either the fair value or the previous GAAP carrying amount of the investment at the entity's date of transition to FRSs (see paragraphs 23A and 23B of the draft amendments to FRS 101 and paragraphs BC8–BC13 of the Basis for Conclusions).

Question 1

Do you agree with the two deemed cost options as they are described in this exposure draft? If not, why?

Question 2—Change in scope

The exposure draft proposes that the deemed cost option should be available for the initial measurement of investments in jointly controlled entities and associates when an entity adopts FRSs in its separate financial statements (see paragraph BC14 of the Basis for Conclusions).

Question 2

Do you agree with the proposal to allow the deemed cost option for investments in jointly controlled entities and associates? If not, why?

Questions 3 and 4—Cost method

The exposure draft proposes to delete the definition of the ‘cost method’ from FRS 27. Additionally, the exposure draft proposes to amend FRS 27 to require an investor to recognise as income dividends received from a subsidiary, jointly controlled entity or associate in its separate financial statements. The receipt of this dividend requires the investor to test its related investment for impairment in accordance with FRS 36 *Impairment of Assets* (see paragraphs 4 and 37B of the draft amendments to FRS 27 and paragraphs BC15–BC20 of the Basis for Conclusions).

Question 3

Do you agree with the proposal to delete the definition of the cost method from FRS 27? If not, why?

Question 4

Do you agree with the proposed requirement for an investor to recognise as income dividends received from a subsidiary, jointly controlled entity or associate and the consequential requirement to test the related investment for impairment? If not, why?

Question 5—Formation of a new parent

The exposure draft proposes that in applying paragraph 37(a) of FRS 27 to the formation of a new parent, the new parent should measure cost using the carrying amounts in the separate financial statements of the existing entity at the date of the formation (see paragraph 37A of the draft amendments to FRS 27 and paragraphs BC21 and BC22 of the Basis for Conclusions).

Question 5

Do you agree with the proposed requirement that, in applying paragraph 37(a) of FRS 27, a new parent should measure cost using the carrying amounts of the existing entity? If not, why?

Question 6—Transition

The exposure draft proposes that the amendments to FRS 101 and FRS 27 shall be applied prospectively.

Question 6

Do you agree that prospective application of the proposed amendments to FRS 101 and FRS 27 is appropriate? If not, why?

Proposed amendments to FRS 101 *First-time Adoption of Financial Reporting Standards*

Paragraph 13(ea) is added; a heading and paragraphs 23A and 23B are added; a heading and paragraph 44A are added; and paragraph 47I is added.

13 An entity may elect to use one or more of the following exemptions:

(a) ...

(ea) investments in subsidiaries, jointly controlled entities and associates (paragraphs 23A and 23B);

(f) ...

Investments in subsidiaries, jointly controlled entities and associates

23A If separate financial statements are prepared, FRS 27 *Consolidated and Separate Financial Statements* requires an entity to account for its investments in subsidiaries, jointly controlled entities and associates (unless they are classified as held for sale, or included in a disposal group that is classified as held for sale, in accordance with FRS 105 *Non-current Assets Held for Sale and Discontinued Operations*) either

(a) at cost or

(b) at fair value in accordance with FRS 39 *Financial Instruments: Recognition and Measurement*.

23B In determining cost in accordance with paragraph 23A(a), a first-time adopter may elect to use a deemed cost in its separate financial statements. The deemed cost of a subsidiary, jointly controlled entity or associate shall be its

(a) fair value (determined in accordance with FRS 39) or

(b) previous GAAP carrying amount

at the entity's date of transition to FRSs (in its separate financial statements). A first-time adopter may choose either (a) or (b) above to measure its investment in each subsidiary, jointly controlled entity or associate that it elects to measure using a deemed cost.

Use of deemed cost for investments in subsidiaries, jointly controlled entities and associates

44A If an entity elects to use a deemed cost for the initial measurement of its investment in a subsidiary, jointly controlled entity or associate in its separate financial statements (see [draft] paragraph 23B), the entity's first FRS separate financial statements shall disclose which deemed cost option has been used.

47I An entity shall apply [draft] paragraphs 13(ea), 23A, 23B and 44A for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to FRS 101 and FRS 27), issued in [date to be inserted after exposure], for an earlier period, the amendments shall be applied to that earlier period and it shall disclose that fact.

Proposed amendments to FRS 27 *Consolidated and Separate Financial Statements*

In paragraph 4, the reference to the 'cost method' is deleted; paragraphs 37A, 37B and 43B are added.

4 …

~~**The *cost method* is 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.**~~

…

37A An entity (either a parent or a single entity) might decide to reorganise its operating structure by forming a new parent entity so that the existing entity becomes a wholly-owned subsidiary of the new parent. The new parent is formed in a manner that does not change the relative ownership interests of the owners of the existing entity or the equity, assets and liabilities of the group. In applying paragraph 37(a) to such formations, the new parent shall measure the cost of its investment in the existing entity 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.

37B An investor shall recognise as income in its separate financial statements dividends received from a subsidiary, jointly controlled entity or associate. If the investor accounts for its investment in the subsidiary, jointly controlled entity or associate at cost in accordance with paragraph 37, the receipt of such a dividend is an event that requires the investor to test the related investment for impairment in accordance with FRS 36 *Impairment of Assets*.

43B An entity shall apply the [draft] deletion of the definition of the cost method from paragraph 4 and [draft] paragraphs 37A and 37B for annual periods beginning on or after [date to be inserted after exposure]. Earlier application is permitted. If an entity applies *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to FRS 101 and FRS 27), issued in [date to be inserted after exposure], for an earlier period, the amendments shall be applied to that earlier period and it shall disclose that fact.

Appendix

Amendments to other FRSs

The amendments in this [draft] appendix shall be applied for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate *(Amendments to FRS 101 and FRS 27), issued in [date to be inserted after exposure], for an earlier period, these amendments shall be applied for that earlier period. Amended paragraphs are shown with the new text underlined and deleted text struck through.*

A1 FRS 18 *Revenue* is amended as described below.

In the rubric, the first sentence is amended as follows:

> Financial Reporting Standard 18 *Revenue* is set out in paragraphs 1~~–37~~<u>38</u>. All the paragraphs...

Paragraph 32 is amended and paragraph 38 is added as follows.

> 32 When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognised as revenue. ~~When dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.~~
>
> 38 An entity shall apply the amendment in paragraph 32 for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to FRS 101 and FRS 27), issued in [date to be inserted after exposure], for an earlier period, that amendment shall be applied to that earlier period.

A2 In FRS 21 *The Effects of Changes in Foreign Exchange Rates*, paragraph 49 is amended as follows.

> 49 An entity may dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity. ~~The payment of a dividend is part of a disposal only when it constitutes a return of the investment, for example when the dividend is paid out of pre-acquisition profits.~~ In the case of a partial disposal, only the proportionate share of the related accumulated exchange difference is included in the gain or loss. A write-down of the carrying amount of a foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised in profit or loss at the time of a write-down.

A3 In FRS 36 *Impairment of Assets*, paragraph 10 is amended and paragraph 140B is added as follows.

> **10 Irrespective of whether there is any indication of impairment, an entity shall also:**
>
> **(a) …**
>
> <u>**(c) test an investment in a subsidiary, jointly controlled entity or associate in its separate financial statements for impairment if the entity received a dividend from that investment during the reporting period.**</u>

140B **An entity shall apply the amendment in paragraph 10(c) for annual periods beginning on or after [date to be inserted after exposure]. If an entity applies *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to FRS 101 and FRS 27), issued in [date to be inserted after exposure], for an earlier period, that amendment shall be applied to that earlier period.**

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the proposed amendments to FRS 101 and FRS 27.

Introduction

BC1 This Basis for Conclusions summarises the considerations in reaching the conclusions in *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*, the exposure draft of proposed amendments to FRS 101 *First-time Adoption of International Financial Reporting Standards* and FRS 27 *Consolidated and Separate Financial Statements*.

BC2 The CCDG published *Cost of an Investment in a Subsidiary*, an exposure draft of proposed amendments to FRS 101, in February 2007. The objective was to address the concern that applying FRS 27 with full retrospective effect in determining the cost of an investment in a subsidiary in the separate financial statements of a parent on first-time adoption of FRSs cannot, in some circumstances, be achieved without undue cost or effort. Consequently, this might create a barrier to adoption of FRSs in the separate financial statements of parent entities.

BC3 FRS 27 requires investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale to be accounted for either at cost or at fair value in accordance with FRS 39 *Financial Instruments: Recognition and Measurement* in the separate financial statements of the parent (investor). FRS 27 also requires an entity to recognise income from an investment only to the extent that the entity receives distributions from post-acquisition profits (the 'cost method'). Distributions received in excess of such profits are regarded as a recovery of investment and are recognised as a reduction in the cost of the investment.

BC4 For some jurisdictions, these aspects of FRS 27 have led to practical difficulties on transition to FRSs. Some acquisitions that were share-for-share exchanges were accounted for using so-called 'merger relief' or 'group reconstruction relief' whereby the carrying amount of the investment in the parent's separate financial statements in accordance with local GAAP is based on a nominal value of the shares given rather than the value of the purchase consideration.

BC5 In order to apply FRS 27 retrospectively:

(a) it would be necessary to measure the fair value of the consideration given at the date of acquisition in situations in which merger relief or group reconstruction relief was used to account for the acquisition of the subsidiary; and

(b) it would be necessary to determine whether any dividends paid by the subsidiary after its acquisition were paid out of pre-acquisition profits, which would reduce the carrying amount of the investment in the subsidiary in the parent's separate financial statements.

If a parent has held an investment in a subsidiary for many years, such an exercise may be difficult and potentially costly. In some circumstances, the retrospective application of FRS 27 as described above might not be possible.

BC6 In response to these issues, two exemptions had been proposed from FRS 101:

(a) an alternative approach for determining the cost of an investment in a subsidiary in the separate financial statements of a parent; and

(b) a simplification of the process for determining the pre-acquisition retained earnings of that subsidiary.

The comment period for the IASB exposure draft ended on 27 April 2007. 47 comment letters were received. Respondents expressed concern that the proposals did not reduce the cost of adopting IFRSs in the separate financial statements of a parent sufficiently to justify adoption.

BC7 In the light of the comments received, the Board revised the proposals presented in the January 2007 exposure draft. In accordance with its due process requirements (paragraphs 45–48 of the IASB Due Process Handbook), the Board decided to publish its proposals in the form of a second exposure draft to solicit public comment on the Board's revised tentative decisions. Additionally, during the comment period for that exposure draft, the Board received separate enquiries about the application of IAS 27 in the separate financial statements of a newly formed parent entity. The Board observed that the enquiries also related to the cost of an investment in a subsidiary and, given the timing of its active project on IFRS 1, decided to address the issue in this combined exposure draft.

Proposed amendments to FRS 101

Deemed cost

BC8 In the deliberations for the first exposure draft, three ways of determining a deemed cost of an investment in a subsidiary at the parent's date of transition to FRSs in its separate financial statements had been considered. These were:

(a) the previous GAAP cost of the investment in the subsidiary (previous GAAP deemed cost).

(b) the parent's interest in the carrying amount of the subsidiary's assets less liabilities, using the carrying amounts that FRSs would require in the subsidiary's statement of financial position (net asset deemed cost).

(c) the fair value (measured in accordance with FRS 39) of the investment (fair value deemed cost).

BC9 It was decided that the net asset deemed cost option would provide relevant information to users about the subsidiary's financial position at the date of transition to FRSs and would be relatively easy for an entity to determine. The fair value deemed cost option would provide information about the underlying value of a subsidiary at the date of transition to FRSs, but might be more costly and difficult to determine.

BC10 There was concern that, in some situations, the cost of an investment in a subsidiary determined using the previous GAAP carrying amount bore little resemblance to cost determined in accordance with FRS 27. Therefore, it was rejected the use of a deemed cost based on the previous GAAP carrying amount. It was proposed to allow entities a choice between using the net asset value or the fair value of the subsidiary as a deemed cost for the parent's investment in the subsidiary.

BC11 Respondents to the exposure draft thought that a more appropriate deemed cost is the carrying amount of the subsidiary calculated in accordance with the previous GAAP carrying amount. Recurring themes articulated in the comment letters were that:

(a) A net asset deemed cost based on the carrying amounts that FRSs would require in the subsidiary's statement of financial position would not include goodwill or other intangible assets that might otherwise be present in a carrying amount determined under previous GAAP. When this is the case, the net asset deemed cost option would understate the assets of the entities for which it is used. The resulting write-down of the carrying amount of the investment could reduce the distributable profits of the parent.

(b) It was difficult to see why, in the light of the exemption in FRS 101 from applying FRS 103 *Business Combinations* retrospectively, it did not propose to permit the cost of the investment in a subsidiary under previous GAAP to be used as a deemed cost.

When an entity had chosen not to apply FRS 103 retrospectively to a past business combination, it would be logical not to require it to restate the cost of the related investment in the separate financial statements of the parent.

BC12 During the redeliberations, it was observed that it made little sense to add an exemption to FRS 101 that would not be used. In considering the use of previous GAAP carrying amount as deemed cost, it was noted that, in many instances, neither the previous GAAP carrying amount nor the net asset deemed cost represents 'cost'—both numbers could be viewed as being equally arbitrary.

BC13 In order to reduce the cost of adopting FRSs so that the benefit of using them for the preparation of the parent entity's separate financial statements can be realised, it was proposed to allow entities a choice between the previous GAAP carrying amount and the fair value as deemed cost.

Change in scope

BC14 It was agreed with respondents that similar issues arise in practice in relation to investments in associates and jointly controlled entities. Both FRS 28 *Investments in Associates* and FRS 31 *Interests in Joint Ventures* refer to FRS 27 in their requirements for accounting in the investor's separate financial statements. As a result, the deemed cost exemption to be provided in FRS 101 would also apply to investments in associates and jointly controlled entities.

Proposed amendments to FRS 27

Dividends received from a subsidiary, jointly controlled entity or associate

BC15 The cost method in FRS 27 requires an investor to recognise distributions received from the pre-acquisition retained earnings of a subsidiary as a reduction in the cost of the investment. If the investor acquired a subsidiary before the investor's date of transition to FRSs, the investor would need to know the subsidiary's pre-acquisition retained earnings in accordance with FRSs for the purpose of the cost method.

BC16 It was observed that restating pre-acquisition retained earnings would be a task tantamount to restating the business combination (for which FRS 101 provides an exemption in paragraph 15 and Appendix B). It might involve subjective use of hindsight, which would diminish the relevance and reliability of the information. In some circumstances, the restatement would be time-consuming and difficult. In other 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).

BC17 In the first exposure draft, it was proposed to provide an exemption on transition to FRSs 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 investor used the deemed cost option discussed in paragraph BC6.

BC18 In the redeliberations, it was 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 FRS 27 creates a problem in some jurisdictions because it makes specific reference to retained earnings as the means of making that assessment. It was determined that the best way to resolve this issue was to delete the definition of the cost method. It was noted that removing the definition of the cost method also avoids the need to have an exemption for investments in subsidiaries that are measured at deemed cost at the date of transition to FRSs in the separate financial statements of the parent.

BC19 In conjunction with the removal of the definition of the cost method, it was proposed that dividends received by an investor from a related subsidiary, jointly controlled entity or associate should be recognised as income in the separate financial statements of the investor.

BC20 To reduce the risk that removing the definition of the cost method will lead to investments in subsidiaries, jointly controlled entities and associates being systematically overstated in the separate financial statements of the investor, it was proposed that the related investment should be tested for impairment in accordance with FRS 36 *Impairment of Assets*. Investments in a subsidiary, jointly controlled entity or associate are within the scope of FRS 36.

Formation of a new parent

BC21 Enquiries had been received about the application of paragraph 37(a) of FRS 27 to situations in which an entity (either a parent or a single entity) decides to reorganise its operating structure by forming a new parent entity so that the existing entity becomes a wholly-owned subsidiary of the new parent. The new parent is formed in a manner that does not change the relative ownership interests of the owners of the existing entity or the equity, assets and liabilities of the group. Some interpret paragraph 37(a) as requiring the new parent to measure its investment in the existing entity at the fair value of the existing entity at the date when the new parent is formed. The basis for this view is that cost in accordance with paragraph 37 is the fair value of the consideration given. In the case of the formation of a new parent, cost would be the fair value of the shares issued by the new parent. The fair value of the shares issued by the new parent would be measured by reference to what was received. Accordingly, the investment in the existing entity would be measured at the fair value of the existing entity.

BC22 It was 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. Therefore, it was decided that in the limited circumstances in which an entity reorganises its operating structure in this manner, the new parent should measure cost in applying paragraph 37(a) of FRS 27 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.