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Measuring investments in subsidiaries, jointly controlled entities and associates on first-time adoption

On 22 May 2008, the International Accounting Standards Board (IASB) published amendments to IFRS 1 **First-time Adoption of International Financial Reporting Standards** and IAS 27 **Consolidated and Separate Financial Statements** dealing with the measurement of the cost of investments in subsidiaries, jointly controlled entities and associates when adopting International Financial Reporting Standards (IFRSs) for the first time. The Board has made these amendments because of concerns that retrospectively determining cost and applying the cost method in accordance with IAS 27 could not, in some circumstances, be achieved without undue cost or effort for first-time adopters.

The amendments to IFRS 1 and IAS 27 are effective for annual periods beginning on or after 1 January 2009, with earlier application permitted (see page 3).

Measurement of investments in subsidiaries

IAS 27 **Consolidated and Separate Financial Statements** requires a parent, in its separate financial statements, to account for its investments in subsidiaries, jointly controlled entities and associates either at cost or in accordance with IAS 39 **Financial Instruments: Recognition and Measurement**. This requirement presented a problem for some parent entities when IFRSs were adopted for the first time, in circumstances where the parent was unable to determine cost in accordance with IFRSs, but was 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.

Following revision, IFRS 1 permits a first-time adopter that has chosen to account for such investments at cost, to measure that cost using a 'deemed cost' approach. This deemed cost can be determined as either:

- fair value (determined in accordance with IAS 39) at the entity's date of transition to IFRSs in its separate financial statements; or
- the previous GAAP carrying amount of the investment at that date.

First-time adopters are 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 fair value and the previous GAAP carrying amount will be made on an individual investment basis.

Disclosures required where deemed cost is used

An entity that has elected to use the deemed cost alternative available under the revised IFRS 1 in its opening IFRS statement of financial position is required to disclose the following in its first IFRS financial statements:

- the aggregate deemed cost of those investments for which deemed cost is their previous GAAP carrying amount;
- the aggregate deemed cost of those investments for which deemed cost is fair value; and
- the aggregate adjustments to the carrying amounts reported under previous GAAP.

Recognition of dividends from subsidiaries, jointly controlled entities and associates

Prior to amendment, IAS 27 also required a parent to recognise distributions received from the pre-acquisition accumulated profits of a subsidiary, associate or joint venture accounted for using the cost method as a reduction in the cost of the investment. Again, this caused a potential problem for first-time adopters because, if the parent had 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 has therefore removed from IAS 27 the requirement to distinguish between pre- and post-acquisition dividends. The Standard now applies the general requirements of IAS 18 **Revenue** and requires that dividends received from subsidiaries, jointly controlled entities and associates be recognised in profit or loss when the entity's right to receive the dividend is established.

An indicator of impairment

To address concerns that the new rules for recognition of dividends could result in inappropriate recognition of profit, IAS 36 **Impairment of Assets** has been amended by the introduction of a new indicator of impairment.

In assessing whether a full impairment test is required for an investment in a subsidiary, jointly controlled entity or associate, an entity is required to consider whether it has recognised a dividend from the investment and evidence is available that:

- the carrying amount of the investment in the separate financial statements exceeds the carrying amount in the consolidated financial statements of the investee's net assets; or
- the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period in which the dividend is declared.

Reorganisations by establishing a new parent

IAS 27 has also been amended to deal with circumstances where a parent reorganises the structure of its group by establishing a new entity as its parent. In such reorganisations, the new parent obtains control of the original parent by issuing equity instruments in exchange for equity instruments of the original parent. Under the new rules, in a reorganisation that meets specified criteria, the new parent measures the cost of its investment in the previous parent at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent at the date of the reorganisation.

Effective date and transition

The amendments to IFRS 1 are effective for annual periods beginning on or after 1 January 2009, with early application permitted.

The amendments to IAS 27 regarding the recognition of dividends from subsidiaries, associates and jointly controlled entities (and consequential amendments to IAS 18 **Revenue** and IAS 36 **Impairment of Assets**) are also to be applied for annual periods beginning on or after 1 January 2009, with early application permitted. These amendments are to be applied prospectively.

The amendments to IAS 27 regarding group reorganisations are generally to be applied prospectively to reorganisations that occur in annual periods beginning on or after 1 January 2009, with early application permitted. The amendments may be applied retrospectively to past reorganisations falling within their scope provided that, where an entity restates any reorganisation in line with the amended Standard, it also restates all later qualifying reorganisations.

Where any of the amendments are applied before their effective dates, that fact should be disclosed.

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