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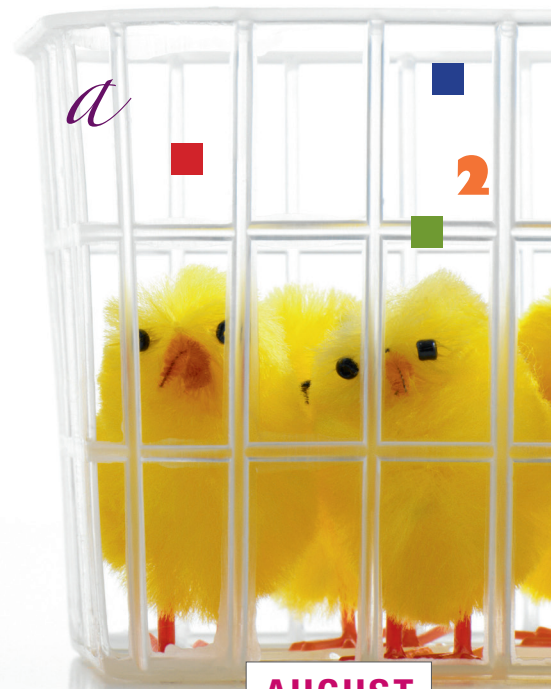
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ZEAK

Separate Financial Statements DISCUSSION PAPER



**AUGUST
2014**

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This Discussion Paper is issued by the European Financial Reporting Advisory Group (EFRAG), the Spanish Instituto de Contabilidad y Auditoría de Cuentas (ICAC), the Italian Organismo Italiano di Contabilità (OIC) and the Dutch Raad voor de Jaarverslaggeving (RJ).

The following standard setters in Europe also support the issue of this Discussion Paper:

Belgium, CNC/CBN - Commissie voor Boekhoudkundige Normen/Commission des Normes Comptables
Cyprus, ICPAC - Institute of Certified Public Accountants of Cyprus
Denmark, FSR - Danske Revisorer
Estonia, EASB - Eesti Raamatupidamise Toimkond
Latvia, Ministry of Finance, Republic of Latvia
Lithuania, AAA - Audito ir Apskaitos Tarnyba
Luxembourg, CNC - Commission des Normes Comptables
Malta, MIA - The Malta Institute of Accountants
Norway, NRS - Norsk RegnskapsStiftelse
Poland, KSR - Polish Accounting Standards Committee
Slovenia, Slovenski Institut za Revizijo

DISCLAIMER

These bodies, while encouraging debate on the issues presented in the paper, do not express any opinion on those matters at this stage.

Copies of the Discussion Paper are available from the websites of those bodies issuing it. A limited number of copies of the Discussion Paper will also be made available in printed form, and can be obtained from EFRAG.

The paper invites comments on its proposals via the 'Questions for Respondents' at the end of each section (which are summarised in the Invitation to Comment). Such comments should be sent by email to:

commentletters@efrag.org or by post to:

*EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium*

so as to arrive no later than 31 December 2014.

All comments received will be placed on the public record unless confidentiality is requested.

EFRAG's Proactive Work in Europe

It is important to set the project on separate financial statements within the broader context of our Proactive work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. This proactive work is carried out in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level. Four strategic aims underpin proactive work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- Influencing the development of global financial reporting standards;
- Providing thought leadership in developing the principles and practices that underpin financial reporting; and
- Promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our proactive work and current projects is available on the EFRAG website (www.efrag.org).

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WHY A PROJECT ON SEPARATE FINANCIAL STATEMENTS?

- ES1 European constituents, in responding to the consultation on EFRAG's proactive work, supported a project on separate financial statements (as defined in paragraph 4 of IAS 27 *Separate Financial Statements*) outlining the reasons and concerns described below.
- ES2 In addition, the Italian Standard Setter (OIC) and EFRAG joint proactive project that resulted in a Discussion Paper on *Accounting for Business Combinations under Common Control* (BCUCC) showed that the information needs of users of consolidated and separate financial statements may differ. Although accounting for BCUCC in separate financial statements was not dealt with in that project, the Discussion Paper highlighted the need for further work on the application of IFRS in separate financial statements.
- ES3 To address the concerns that have been raised, in June 2011 the EFRAG Planning and Resource Committee decided to launch a project on separate financial statements. The project is a partnership between EFRAG, the Spanish Standard Setter (ICAC), the OIC and the Dutch Standard Setter (RJ). This paper considers how separate financial statements are used in Europe for economic decision-making, and analyses the technical financial reporting issues that arise under IFRS when preparing such financial statements.

WHAT ARE THE CONCERNS WITH SEPARATE FINANCIAL STATEMENTS?

- ES4 It is well-established that the financial statements presented by a single entity, such as a parent or an investor (whether prepared under IFRS or Local GAAP), provide decision-useful information to users. For example, they provide information about the distribution of dividends, the repayment of capital and the existence of guarantees. They also serve a critical role in determining compliance with legal requirements in numerous jurisdictions, for instance, to determine the applicable tax policy and to determine insolvency or bankruptcy.
- ES5 It is also well-known that in June 2002, the European Union (EU) adopted a Regulation on the application of international accounting standards (Regulation No. 1606/2002) which provides, among other things, the option to Member States to permit or require companies to prepare their annual accounts / annual financial statements in conformity with IFRS.

ES6 For those applying IFRS to the financial statements presented by a parent or an investor, or, more specifically, to separate financial statements, there have been practical concerns about the relevance of some of the requirements under IFRS because the focus of IFRS is, generally, on the preparation of consolidated financial statements and, hence, silent or unclear on how to deal with some accounting issues in separate financial statements. For example, lenders and other creditors argue that the usefulness of separate financial statements can be impaired when entities within the same group enter into transactions with each other that are not necessarily structured or priced on an arm's length basis. In such circumstances, the amounts reported in the separate statements reflect internal transactions and not transactions with third non-related parties. Similarly, as disclosure requirements in IFRS are often focused on consolidated financial statements, the question has been raised whether the IFRS requirements may have to be amended to properly deal with disclosures within the context of separate financial statements. Questions have also been raised whether there should be symmetry in the accounting for transactions or events in the separate and consolidated financial statements. It is also worth noting that the IFRS Interpretations Committee has received many questions within the context of the current IFRS for which guidance on separate financial statements is, as indicated above, missing or unclear.

ES7 In addition, considering the fact that:

- a) The majority of the European countries, including the Netherlands and Italy, permit or require the use of IFRS in the annual accounts;
- b) Some of the European countries that do not permit or require the use of IFRS in the annual accounts, such as Spain, are in the process of aligning their Local GAAP with IFRS; and
- c) A number of other European countries have been closely following the discussions on separate financial statements before permitting or requiring companies to use IFRS in the annual accounts,

any guidance related to separate financial statements, particularly in transactions between group companies, would be very helpful to them.

HOW SHOULD THOSE CONCERNS BE ADDRESSED?

- ES8 This Discussion Paper includes several different views or ways of looking at a number of financial reporting concerns identified by those who apply and use separate financial statements under IFRS. In some cases, the Discussion Paper may identify one or more preferred views. However, we acknowledge that there are no ideal approaches, and that the accounting will, on every occasion, depend on facts and circumstances of each transaction and how the transaction impacts the decisions of users.
- ES9 Most importantly, we want to make sure that the issues identified by the users of separate financial statements have been comprehensively debated and that any future accounting resolution for separate financial statements is appropriate and aligned with current IFRS, the *Conceptual Framework for Financial Reporting* (the ‘*Conceptual Framework*’) and the needs of users of separate financial statements.
- ES10 In regard to the issues referred by those who apply and use separate financial statements under IFRS, our analysis in chapters 2 and 3 lead us to conclude that it is important to:
- a) **Clarify the objective of separate financial statements:** as a starting point, we believe it is essential to clarify the objective of separate financial statements and draw, in IAS 27, a clear distinction between separate financial statements and other financial statements outlined in IFRS. Such clarification would provide a more robust basis for the preparation of separate financial statements, particularly when the application of IFRS to separate financial statements give rise to practical implementation difficulties;
 - b) **Develop guidance on how to account for transaction costs and contingent consideration in separate financial statements:** from our analysis, we consider that it would be useful to have guidance in IAS 27 on how to account for contingent consideration and transaction costs related to the acquisition of an investment in a subsidiary, joint venture or associate. In particular, whether contingent consideration and transaction costs related to the acquisition of investments in separate financial statements should follow an ‘asset acquisition’ (as in IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Property*) or a ‘business combination’ (IFRS 3 *Business Combinations*) accounting model;
 - c) **Have a comprehensive debate on common control transactions, regardless of whether they represent a business combination under common control, as the method of accounting for such transactions may impair the usefulness of separate financial statements:** common control transactions may have a significant impact on the separate financial statements of an entity. This is because of the effects of non-arm’s length intragroup transactions and the fact that intragroup transactions and outstanding balances are not eliminated in the separate financial statements of an entity. This raises the question of whether the

current IFRS requirements need to be reconsidered when dealing with common control transactions in the separate financial statements. As a starting point for our discussion, we present and discuss a number of different alternatives on how to account for common control transactions and indicate the benefits and challenges of each alternative proposed. For example, we present a number of different measurement bases that could be used for initial measurement of an investment acquired in a common control transaction: (i) transaction cost approach; (ii) fair value approach, and (iii) carrying amount approach;

- d) **Consider the accounting for business combinations under common control in the acquirer's separate financial statements, including legal mergers:** as IFRS 3 may be applied in the separate financial statements in certain circumstances (e.g. the acquisition of a group of assets and liabilities that constitutes a business as defined in IFRS 3 and are not in a vehicle), then there is a need to consider the issue of how to account for business combinations under common control in the separate financial statements of the acquirer. In addition, groups often enter into corporate restructurings, such as legal mergers, to simplify the structure of the group or achieve tax benefits. Considering that such mergers typically involve entities under common control, the issue of business combinations under common control arises once more; and
- e) **Strengthen the disclosures on distributions to equity holders:** users have indicated that they would welcome more detailed disclosures about distributable dividends. This Discussion Paper puts forward some suggestions on how to address users' concerns and improve the quality of disclosures.

MOVING FORWARD

ES11 We believe that this Discussion Paper and the IASB's recent discussions on the use of the equity method in separate financial statements (IASB's ED/2013/10 *Equity Method in Separate Financial Statements*) demonstrate that there is a need for the IASB to consider, as part of its research activities, the role of separate financial statements and the challenges that arise in practice to those who prepare and use separate financial statements.

ES12 We also believe that in the development of each new standard or amendment, the IASB should consider whether such standard or amendment:

- a) Creates any difficulties or implementation issues to those who prepare and use separate financial statements; and
- b) Should be applied to separate financial statements.

Questions to constituents

EFRAG, the Spanish Standard Setter (ICAC), the Italian Standard Setter (OIC) and the Dutch Standard Setter (RJ) invite comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

- a) Address the question as stated;
- b) Indicate the specific paragraph reference, to which the comments relate; and/or
- c) Describe any alternative approaches we should consider.

All comments should be received by 31 December 2014.

Question 1 - Introduction

Chapter 1 starts by providing the objective of this Discussion Paper, and then sets the framework of separate financial statements in Europe. In particular, it highlights the legal role of separate financial statements in Europe, describes the European legislative framework on financial reporting, and draws a parallel between separate and consolidated financial statements.

Q1.1 Do you believe that chapter 1 appropriately sets out the framework of separate financial statements in Europe? If not, what should be changed in chapter 1 and why? Please explain.

Questions 2.1, 2.2 and 2.3 - The use of financial statements of a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP

In chapter 2 we have identified a wide range of users of financial statements (under IFRS or Local GAAP) of a legal entity: equity investors, debt providers, other creditors, tax authorities, regulatory authorities and other interested parties, which have or intend to have transactions with the entity. Nonetheless, the relevance and level of use of such financial statements depends significantly on the type of user. For example, some users only look for very specific information (e.g. distributable dividends), while others examine financial statements more comprehensively (e.g. assess credit worthiness). We have also highlighted in this chapter that debt providers and legal/regulatory authorities have been identified as primary users of these financial statements.

Q2.1 Do you agree with the description provided in chapter 2 of the use of financial statements of a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP? Please explain.

Q2.2 Considering the wide range of users of financial statements of a legal entity identified in the Discussion Paper, do you believe that paragraphs 2.13 to 2.17 accurately identify the primary users of separate financial statements? Please explain.

Q2.3 In your experience, are there any additional users of financial statements of a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP? If so, could you please identify the other users of such financial statements?

Question 3.1 - Accounting policies to be applied in separate and consolidated financial statements

Apart from a reference in IAS 27, IFRS do not explicitly deal with separate financial statements and the overriding assumption is that the same accounting policies and basis for presentation should apply to separate and consolidated financial statements. This has resulted in some raising questions of whether there is a different or modified objective for separate financial statements, and hence, whether the accounting policies to be applied to either set of financial statements should differ. For example, when an entity acquires a group of assets and liabilities that constitutes a business, should such an acquisition be accounted for as a business combination in accordance with IFRS 3 (same accounting treatment as in consolidated financial statements), or should it be accounted for differently? This issue is considered throughout chapter 3, especially when considering what changes, if any, are necessary to current IFRS guidance on separate financial statements.

Q3.1 In which cases, if any, do you believe that the accounting policies applied to either set of financial statements should differ? Please explain.

Questions 3.2 and 3.3 - Accounting for transaction costs and contingent consideration

IAS 27 does not provide any specific guidance on the initial measurement of investments when an entity opts to account for such investments at cost. It is, therefore, unclear how one should account for certain transactions or events such as 'transaction costs' and 'contingent consideration'. In chapter 3 of this Discussion Paper, it is suggested that when an entity opts to account for its investments at cost in its separate financial statements, transaction costs should be part of the initial measurement of investments and that contingent consideration should be accounted for as part of the initial and subsequent measurement of investments.

Q3.2 Do you consider that acquisition-related costs should be expensed or should be part of the initial measurement of investments in subsidiaries, joint ventures or associates accounted for at cost in the separate financial statements? Please explain.

Q3.3 Do you consider that contingent consideration should be accounted for in accordance with IFRS 3 or should be accounted for as part of the initial and subsequent measurement of investments in subsidiaries, joint ventures or associates accounted for at cost in the separate financial statements? Please explain.

Questions 3.4, 3.5, 3.6 and 3.7 - Sale or contribution of equity investments between entities under common control

IAS 27 does not deal specifically with or scopes out the accounting for transactions of equity investments (in a subsidiary, joint venture or associate) between entities under common control. Therefore, an entity has to apply the general accounting principles in IAS 27 and IAS 24 *Related Party Disclosures* for common control transactions. However, the usefulness of the outcome may be questioned as these transactions may not be subject to market forces. Considering that users of separate financial statements need information to assess the economic resources available to repay debt and pay dividends, it is suggested in chapter 3 that the use of the fair value (i.e. the application of IAS 39/ IFRS 9 *Financial Instruments*) would provide relevant information about the economic value of investments, particularly when the transaction price does not represent the fair value of an asset or a liability at initial recognition as described in paragraph B4 of IFRS 13 *Fair Value Measurement*.

Q3.4 Do you agree that the IASB needs to set out specific accounting requirements for the acquisition of investments from entities under common control in the separate financial statements? Please explain.

Q3.5 In your view, which of the approaches presented in paragraph 3.66 of the Discussion Paper provides more relevant information to users? Please explain.

Q3.6 If an entity applies the 'fair value' approach or 'carrying amount' approach (as described in paragraph 3.66 of the Discussion Paper), how should it account for any difference between the 'transaction price' and the amount of investment initially recognised at 'fair value' or 'carrying amount'? Please explain.

Q3.7 Do you think that the use of the fair value method (i.e. the application of IAS 39/ IFRS 9) is the most appropriate option to account for investments acquired by entities under common control? Please explain.

Question 3.8 - Business combinations and separate financial statements

When an entity prepares separate financial statements, it must apply not only IAS 27 but also other relevant standards. Consequently, business combination accounting (IFRS 3) may be used in the separate financial statements in certain circumstances, namely when an entity acquires a group of assets and liabilities that constitute a business as defined in IFRS 3. Assuming that business combination accounting (IFRS 3) may be used in the separate financial statements, then the key question is how to account for the acquisition of a group of assets and liabilities that constitute a business as defined in IFRS 3 when all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the business combination, and that control is not transitory. This Discussion Paper suggests that the issues raised in the BCUCC Discussion Paper are also applicable to separate financial statements; that the recognition and measurement principles should be driven by how the transaction impacts the decisions of users, and that the accounting of BCUCC in separate financial statements depends on facts and circumstances of each transaction.

Q3.8 In your view, what is the most appropriate approach to account for a business combination between entities under common control in the separate financial statements? Please explain.

Questions 3.9 and 3.10 - Legal Mergers

Although ‘true mergers’ or ‘mergers of equals’ are discussed in IFRS 3, where they are classified as business combinations, mergers of entities under common control are out of the scope of IFRS 3. In the absence of explicit guidance and considering that the financial statements of the legal entities involved in a merger between entities under common control can be significantly impacted, the issue is how to account for legal mergers in the separate financial statements of the acquirer. From our analysis, we consider that it is useful to use:

- The carrying amounts in the consolidated financial statements of the acquirer (see paragraph 3.109); or
- The carrying amounts in the separate financial statements of the acquiree.

Q3.9 Do you agree that both the approaches described above can provide decision useful information to users of separate financial statements? Please explain.

Q3.10 In your view, which of the approaches described in paragraphs 3.110 – 3.113 provides, when applied in practice, more relevant information to users? Please explain.

Questions 3.11 and 3.12 - Disclosures on distributions to equity holders in the separate financial statements

During the research phase, users have indicated that financial statements often failed to provide enough information to determine the amounts available to be distributed to equity holders and that they would welcome more detailed disclosures about distributable dividends. To address user’s needs it is suggested that companies should be required to disclose the impact of externally imposed capital requirements on the entity’s ability to transfer funds to its shareholders in the form of cash dividends; to disclose how much of an entity’s income is to be allocated to the creation or increase of any type of reserves in order to comply with externally imposed capital requirements; and to disclose an entity’s total amount of income and reserves which are, legally, available to be distributed. We also believe it would be useful if companies would present, in all cases, line items in the statement of financial position reflecting accumulated amounts that may or not be recycled to profit or loss.

Q3.11 Do you think that additional disclosures about distributable dividends are necessary in the separate financial statements? Please explain.

Q3.12 Do you think that all the cumulative amounts of gains or losses recognised in Other Comprehensive Income ('OCI') that will be reclassified (recycled) to profit or loss should be always presented in the statement of financial position as a separate component of equity? Please explain.

Question 3.13 - Clarification of the current terminology under IFRS

Our research revealed that many national standard setters and preparers thought that IAS 27 did not clearly explain the objective of separate financial statements and did not draw a distinction between 'separate financial statements' and other financial statements such as 'individual financial statements'. We consider that IFRS could be improved if the objective of separate financial statements was clarified and the different types of financial statements, which are referred in IFRS (e.g. separate and individual financial statements), were clearly defined. We also question the usefulness of the presentation of separate financial statements in addition to financial statements of an investor that does not have subsidiaries and the investments are accounted for under IAS 28 *Investments in Associates and Joint Ventures*.

Q3.13 Do you agree with our tentative view as described above? Please explain.

Questions 3.14 and 3.15 - Other issues

We acknowledge there are a number of other financial reporting areas related to separate financial statements which have not been addressed in this Discussion Paper. For example, a number of issues related to separate financial statements have been recently discussed by the IASB within its project on the use of the equity method in separate financial statements (ED/2013/10). Those issues have not been addressed in this Discussion Paper as they either have already been addressed in a comment letter to the IASB (e.g. *Equity Method in Separate Financial Statements*, which was published on 11 February 2014), or were not considered to have a significant impact on financial reporting.

Q3.14 Do you think there are any other significant issues regarding separate financial statements under IFRS which have not been addressed in this paper? Please explain.

Q3.15 Do you have any other comments related to separate financial statements?

Chapter 1: Introduction

OBJECTIVE OF THE DISCUSSION PAPER

- 1.1 The objective of the Discussion Paper is to consider what changes, if any, are necessary to IFRS requirements to ensure that users of separate financial statements have access to information that is useful and necessary for decision-making – considering the possibility that separate financial statements have a different informational use to that of consolidated financial statements.
- 1.2 The Discussion Paper initially focuses on identifying the users of financial statements presented by a parent or an investor (regardless of whether prepared under IFRS or Local GAAP), their information needs and how such financial statements are used in Europe for economic decision-making. As delineated in chapter 2, the Discussion Paper considers not only the information needs of investors, lenders and other creditors (IFRS primary users as identified in the *Conceptual Framework*) but also of other user groups such as those trading with the entity, or wanting to trade with it (details are presented in Appendix 4).
- 1.3 A wide approach has been chosen in the research phase, which includes financial statements other than those prepared under IAS 27 *Separate Financial Statements*, with the objective of getting input as to how financial statements of a parent or investor are used in general. The underlying thought was that it might be possible to get valuable insight into the use of separate financial statements by considering usage more generally.
- 1.4 In chapter 3, the Discussion Paper proceeds with a technical analysis focused on IFRS requirements of separate financial statements, as this is where issues arise for the European entities that are required or allowed to apply IFRS to these statements. This chapter encompasses issues such as measurement of investments, common control transactions and disclosures that are necessary to satisfy the needs of the users of separate financial statements.

DEALING WITH THE DIFFERENT TERMS USED IN PRACTICE

- 1.5 In the European financial reporting landscape, there is a lack of common terms and definitions between IFRS and EU accounting legislation. This often leads to a misunderstanding of terms such as ‘annual accounts’, ‘separate financial statements’ and ‘individual financial statements’, depending on whether the topic is considered from the perspective of the legal framework or of IFRS requirements.

- 1.6 In addition, the term ‘individual financial statements’ is not defined in IFRS, although it is mentioned in IAS 21 *The Effects of Changes in Foreign Exchange Rates* (paragraphs 32 and 33), IAS 32 *Financial Instruments: Presentation* (paragraph AG29A), IAS 39 *Financial Instruments: Recognition and Measurement* (paragraphs 73 and 80) and IAS 40 *Investment Property* (paragraph 15). Some of the IFRS literature published by accounting firms and consulting service companies (for instance ‘Insights Into IFRS’, KPMG, 2013/2014) refer to individual financial statements as those presented by an entity that does not have subsidiaries, but has investments in associates and/or joint ventures that are accounted for using the equity method.
- 1.7 Therefore, the first hurdle of this project to be cleared relates to definitions. There is a need for a common terminology that can be used throughout the Discussion Paper. The terminology used in this paper reflects the terminology of IFRS when applicable.
- 1.8 Defined terms used throughout this paper are found in Appendix 2 - *Defined terms* where the following key terms are presented:
- a) **Separate financial statements** are those presented by a parent or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IAS 39 /IFRS 9 *Financial Instruments* (in accordance with paragraph 4 of IAS 27);
 - b) **Individual financial statements** (this term is not defined under IFRS) are those presented by an entity that is neither a parent nor an investor with joint control of, or significant influence over, an investee. Although individual financial statements, as defined in this Discussion Paper, may be prepared under IFRS, such financial statements are not in the scope in this Discussion Paper. However, some of the topics referred in this Discussion Paper, such as disclosures on dividends, are also applicable to individual financial statements; and
 - c) **Annual accounts (or annual financial statements)** refer to the financial statements which are presented by a legal entity, as described in the EU accounting directives.

THE LEGAL ROLE OF SEPARATE FINANCIAL STATEMENTS

- 1.9 Separate financial statements (e.g. of a parent) have a significant legal role in Europe. This is because it is the legal entity, and not the group itself, that has a legal standing in the eyes of the law, and has the legal capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, is responsible for paying dividends and salaries, and is held responsible for its actions.

- 1.10 Given their legal importance, separate financial statements are considered useful to a wide range of users such as equity investors, debt providers, employees, other creditors, prudential and market regulators, tax authorities and customers, in making economic decisions about any kind of interest that a user has or will have in the single entity.
- 1.11 Those economic decisions may involve buying, selling or holding equity and debt instruments (namely when considering dividend flows that are paid out of the parent entity), defining applicable tax policy, providing loans to an entity, assessing the level of compliance with market regulations, assessing the stewardship of an entity's resources, assessing the accountability of the entity's management, and bankruptcy proceedings. To make such economic decisions, users often need information from the financial statements of the legal entity that helps them assess a company's ability to generate enough cash to distribute dividends to its shareholders or to repay debt to its debt providers. They also need information about the economic resources of and the claims against the legal entity to assess its creditworthiness.
- 1.12 It is important to bear in mind that users' needs vary and that some user groups may have more use of separate financial statements than others. Some users may have the power to obtain certain information in addition to the financial statements. Nevertheless, many have to rely on the separate financial statements as their major source of financial information when making economic decisions.

EUROPEAN LEGISLATIVE FRAMEWORK ON FINANCIAL REPORTING

- 1.13 In July 1978 the Council of the European Communities adopted the Fourth Council Directive. The Fourth Directive coordinates Member States' provisions concerning the presentation and content of 'annual accounts'. The term 'annual accounts' refers to the financial statements that are presented at the end of a financial year by a company (i.e. by a legal entity). In June 2013, the European Parliament and the Council adopted a new directive on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings. The new directive refers to annual financial statements but other directives still refer to annual accounts, although both terms continue to refer to a legal entity.
- 1.14 In June 2002, the European Parliament and the Council of the European Union adopted a Regulation on the application of International Accounting Standards (Regulation No. 1606/2002, the 'IAS Regulation') requiring European companies that have securities admitted to trading on an EU regulated market to prepare their consolidated financial statements in accordance with IFRS for each financial year starting on or after 1 January 2005. Member States have the option to permit or require companies that have securities admitted to trading on an EU regulated market to prepare annual accounts in conformity with IFRS.

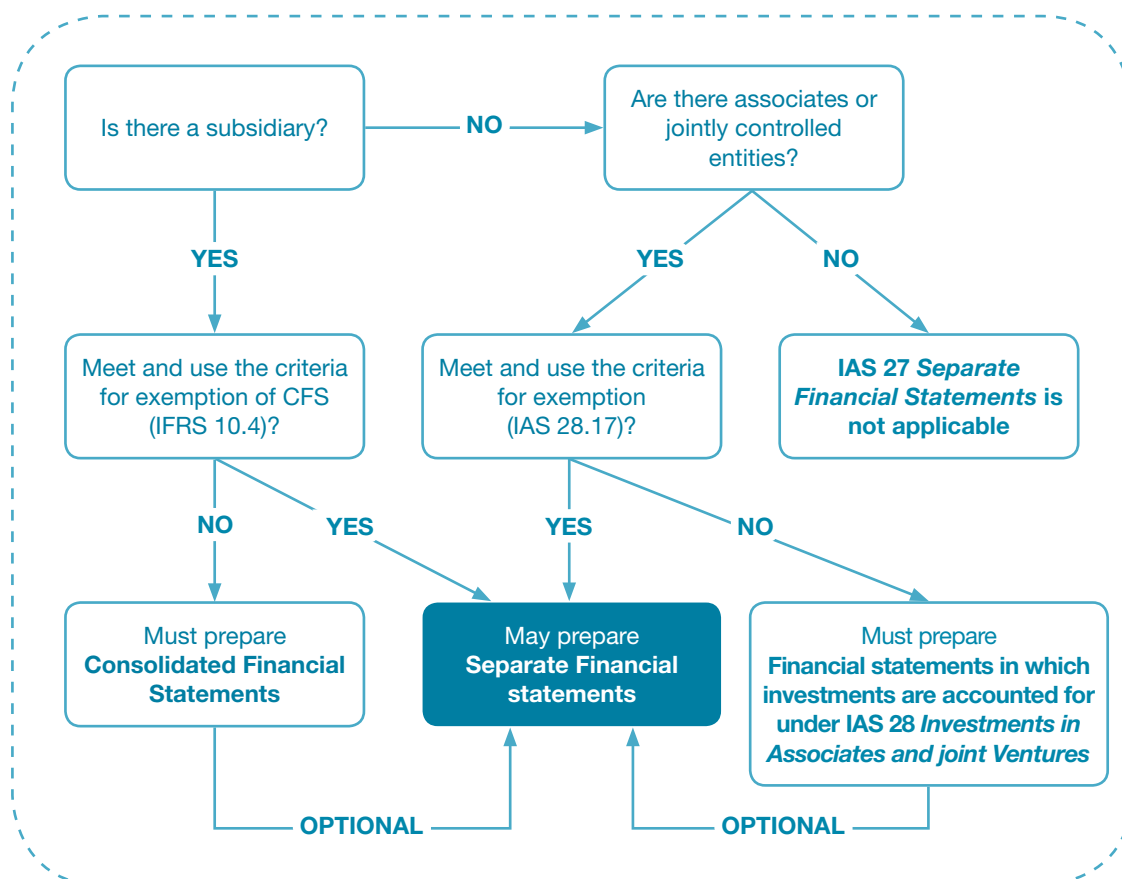
- 1.15 In addition, Member States have the option to permit or require companies that do not have securities admitted to trading to prepare their annual accounts in conformity with IFRS. It is worth noting that although the IAS Regulation requires consolidated accounts of publicly traded companies to be prepared in accordance with IFRS, it never requires companies to prepare annual accounts (or annual financial statements) in conformity with IFRS, even when those companies have securities admitted to trading on an EU regulated market.
- 1.16 The use of options within the IAS Regulation has led European Member States and EEA countries to having many different positions and approaches on the use of IFRS when preparing annual accounts.
- 1.17 Based on the table with the implementation status of the IAS Regulation (1606/2002) in the 31 countries that are part of the EU and the EEA (see Appendix 1), it is apparent that a majority of the countries permit or require the use of IFRS in the annual accounts under the IAS Regulation.

Type of company	Permit or require the use of IFRS in the annual accounts	Do not permit the use of IFRS in the annual accounts
European companies listed in an EU securities market	25	6
European companies unlisted in an EU securities market	25	6

- 1.18 Although most countries permit or require the use of IFRS in the annual accounts, there are variations in the way the option included in the IAS Regulation has been incorporated into national law. For example, when considering the 25 countries that permit or require the use of IFRS in the annual accounts for listed companies, 16 of them require the use of IFRS. However, that requirement is not always applied to all types of listed companies. There are situations where, for example, it only applies to some types of listed companies, which do not prepare consolidated accounts (please see Appendix 1 for further details).

CURRENT IFRS GUIDANCE ON SEPARATE FINANCIAL STATEMENTS

- 1.19 Currently IFRS define two different sets of financial statements: consolidated financial statements and separate financial statements.
- 1.20 IAS 27 provides the specific guidance to be applied when an entity prepares its separate financial statements that comply with IFRS. Mainly, it prescribes the accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates.
- 1.21 Although IAS 27 does not mandate which entities should prepare separate financial statements, it explains that separate financial statements may be presented in addition to consolidated financial statements or financial statements in which investments in associates or joint ventures are accounted for using the equity method (paragraph 6 of IAS 27) or may, under certain circumstances, be presented as an entity's only financial statements (paragraph 8 which refers the exemptions provided by paragraph 4(a) of IFRS 10 *Consolidated Financial Statements* and paragraph 17 of IAS 28 *Investments in Associates and Joint Ventures*). It also clarifies that financial statements of an entity that does not have a subsidiary, associate or joint venture, or in which the equity method is applied, are not separate financial statements.
- 1.22 The IFRS pronouncements on the preparation of separate financial statements can be summarised as follows:



- 1.23 In addition, an **investment entity** that is required, throughout the current period and all comparative periods presented, to apply the exception to consolidation for all of its subsidiaries in accordance with IFRS 10 presents separate financial statements as its only financial statements (paragraph 8A of IAS 27).
- 1.24 Finally, a parent or investor that has an interest in a **joint operation** shall account for its interest in the joint operation in accordance with paragraphs 20-22 of IFRS 11 *Joint arrangements*, i.e. a joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant IFRS.
- 1.25 Although separate financial statements are, in most cases, an option under IFRS, Member States may nevertheless require companies to prepare separate financial statements under IFRS (see paragraph 1.15 above).
- 1.26 With regard to how an entity that prepares separate financial statements should account for its investments and interests in subsidiaries, joint ventures, joint operations, associates and financial instruments, IFRS presently¹ requires the following:

	Subsidiaries	Joint Operations	Joint Ventures	Associates	Financial instruments
Separate Financial Statements	At cost or in accordance with IAS 39	Its interest in the assets, liabilities, revenue and expenses in accordance with IFRS	At cost or in accordance with IAS 39	At cost or in accordance with IAS 39	IAS 39

- 1.27 Although IAS 27 includes a definition and a number of specific accounting requirements that must be applied when an entity elects or is required by local regulations to present separate financial statements under IFRS, these financial statements shall be prepared in accordance with all applicable IFRS. Thus, when an entity prepares separate financial statements it must not only apply IAS 27, but also other standards such as IAS 1 *Presentation of Financial Statements*, IAS 18 *Revenue*, IFRS 11 or even IFRS 3 *Business Combinations*, when applicable and not in conflict with the guidance in IAS 27 on the accounting for the investments in subsidiaries, joint ventures and associates.

- 1.28 Finally, paragraph 6 of IAS 27 refers to separate financial statements as those presented in addition to consolidated financial statements. However, as shown in paragraphs 1.21-1.22, separate financial statements do not have such a restricted definition and do not need to always be appended to, or accompany, consolidated financial statements. Paragraph 8 of IAS 27 supports this view by stating that an entity that is exempted from consolidation in accordance with IFRS 10 may present separate financial statements as its only financial statements. For example, in some circumstances an intermediate parent may elect not to prepare consolidated financial statements and instead prepare only separate financial statements. This can occur because IFRS is based, as explained in paragraph BCZ14 of IFRS 10, on the assumption that users may find relevant information for their purposes about an intermediate parent in its separate financial statements.

SEPARATE AND CONSOLIDATED FINANCIAL STATEMENTS IN PARALLEL

- 1.29 Some consider that there should be a certain symmetry in the accounting for transactions or events in the separate and consolidated financial statements. However, others note that even though consolidated financial statements start with the combination of a parent and its subsidiaries, it does not mean that the assets and liabilities within the parent and its subsidiaries should have the same accounting treatment in the separate and consolidated financial statements. For example, a financial liability of the parent company may be classified at amortised cost in the separate financial statements, and, under the fair value option in IAS 39/IFRS 9, at fair value through profit or loss in the consolidated financial statements, to avoid an accounting mismatch.
- 1.30 In addition, on 2 December 2013 the IASB published for public comment Exposure Draft: *Equity Method in Separate Financial Statements (Proposed amendments to IAS 27)*. The proposed amendments to IAS 27 would allow entities to use the equity method to account for investments in subsidiaries in their separate financial statements. In the Basis for Conclusions, the ED noted that if an entity applied the equity method to account for its investments in subsidiaries in separate financial statements, there could be situations where the investor's net assets and profit or loss would not be the same in separate and consolidated financial statements. The ED mentioned one example related to impairment testing of goodwill vs. impairment testing of an investment accounted for under the equity method.
- 1.31 The value of separate financial statements and the reason for differences in accounting treatment between separate and consolidated financial statements are derived from the fact that consolidated and separate financial statements reflect different views: the view of a group and the view of a legal entity.

1.32 The aspects above illustrate that there are, at least, two important conceptual issues to analyse in this Discussion Paper:

- a) Do separate financial statements have different users than those identified as the primary users in the *Conceptual Framework* and do users of separate financial statements have different information needs than users of consolidated financial statements (chapter 2); and
- b) Should the accounting policies to be applied to and disclosures presented in separate financial statements be identical to or different from those applied to or presented in the consolidated financial statements (chapter 3).

Question 1.1 – Introduction

Do you believe that chapter 1 appropriately sets out the framework of separate financial statements in Europe? If not, what should be changed in chapter 1 and why? Please explain.

Chapter 2: Research on the information needs of users

THE IMPORTANCE OF UNDERSTANDING THE INFORMATION NEEDS OF USERS

- 2.1 The central question this project seeks to answer is whether separate financial statements provide information about the financial position, performance and cash flows of an entity that satisfy the needs of users.
- 2.2 To achieve this goal, it was fundamental for EFRAG and its partners to have a thorough understanding of the information needed by the users of separate financial statements.
- 2.3 It was decided that considerations of the information needs of users should also include financial statements prepared under other GAAPs than IFRS, with the objective of getting input as to how financial statements of a parent or investor are used in general. The underlying thought was that it might be possible to get valuable insight into the use of separate financial statements by considering usage more generally.
- 2.4 The outcome of the research activities resulted in a list of major issues for which additional guidance under IFRS is deemed necessary. This list is presented at the end of this chapter, and forms the input to the next chapter, presenting potential solutions to the issues.

OUR RESEARCH ACTIVITIES

Objective of the research activities

- 2.5 To find out about the information needs of users of separate financial statements, EFRAG and its partners conducted research to identify the information that is most relevant to users in making decisions and, at the same time, to understand the practical financial reporting issues that may exist.
- 2.6 To meet the research activities objectives, EFRAG and its partners asked the following key questions that steered the research activities:
 - a) Who are the users of financial statements presented by a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP, and what are their information needs;
 - b) How are those financial statements used in Europe for economic decision-making; and
 - c) What, if anything, is missing or should be changed in the current IFRS guidance about separate financial statements prepared under IFRS?

- 2.7 By the ‘finding out the information needs of users’ we mean identifying the common needs of as wide a range of primary users as possible.

Research activities

- 2.8 EFRAG and its partners collected data through:
- a) A review of the existing literature on the subject, including *The use of Information by Capital Providers – Academic literature review* published by EFRAG/ICAS in December 2013;
 - b) A survey sent to National Standard Setters on the use of separate financial statements in Europe (November 2011 to February 2012);
 - c) Meetings with users’ representative groups;
 - d) Meetings with financial reporting experts; and
 - e) A consultation with users, preparers and academics.
- 2.9 Further details are available in Appendix 3.

OUR RESEARCH RESULTS

The importance of the financial statements of an investor or parent regardless of whether they are prepared under IFRS or Local GAAP

- 2.10 The research activities highlighted the fact that the financial statements of a parent or an investor (regardless of whether they are prepared under IFRS or Local GAAP) have a significant legal role in Europe, and are of special importance for the protection of debt providers and other creditors (capital maintenance).
- 2.11 That importance is related to the fact that:
- a) It is the legal entity that has the capacity to enter into agreements or contracts, to incur and pay debts, and that is responsible for paying dividends and assuming obligations;
 - b) The legal entity often offers no safeguards to third parties beyond the amounts of its net assets, particularly when it comes to companies with limited liability; and
 - c) Many users are not in a position to request reports tailored to meet their particular information needs. They have to rely on general purpose financial statements.

- 2.12 Separate financial statements under IFRS are generally considered relevant when they have a legal in addition to an informative role, i.e. when an EU country permits or requires entities to prepare their annual accounts in conformity with IFRS.

Identified users of the financial statements of an investor or parent regardless of whether they are prepared under IFRS or Local GAAP

- 2.13 We have identified a wide range of users of financial statements (under IFRS or Local GAAP) of a legal entity: equity investors, debt providers, other creditors, tax authorities, regulatory authorities and other interested parties, which have or intend to have transactions with the entity. Still, the relevance and level of use of such financial statements depends significantly on the type of user. For example, some users only look for very specific information (e.g. distributable dividends), while others examine financial statements comprehensively (e.g. assess credit worthiness). It is also worth noticing that although the users of separate and consolidated financial statements might be the same in some circumstances (e.g. debt providers), they often look for different information in each set of financial statements.

- 2.14 **Debt providers** have been identified as primary users of the financial statements of an investor or parent (regardless of whether they are prepared under IFRS or Local GAAP). Those financial statements are often used by debt providers, particularly banks, to assess a company's ability to generate cash to repay its debts. Debt providers also need information about the economic resources of and the claims against a legal entity to assess its creditworthiness. They can be used independently of or together with consolidated financial statements to access information about the entities within a group (e.g. parent or subsidiaries).

- 2.15 **Legal and regulatory authorities** have also been identified as primary users of financial statements. Although legal and regulatory authorities can require legal entities to prepare the information they need, such authorities often look at separate financial statements as the starting point of their assessment. The financial statements of a legal entity are often used to assess company's financial position and compliance with local regulatory requirements. This includes statutory filing according to commercial and bankruptcy laws, and capitalisation requirements (e.g. insurance and banking industry).

- 2.16 Finally, separate financial statements are frequently used by management. Those financial statements are used, for example, to make management decisions about investments in intermediate parents and subsidiaries.
- 2.17 Further details about who are the users of separate financial statements are presented in Appendix 3.

How are the financial statements of an investor or parent used regardless of whether they are prepared under IFRS or Local GAAP?

- 2.18 The outcome of our research activities led us to believe that the financial statements of a parent or an investor (under IFRS or Local GAAP) are important to the users identified above and in Appendix 3 to:
- a) Assess cash dividends to shareholders taking into account any restrictions that might apply;
 - b) Make financing decisions (e.g. creditworthiness);
 - c) Make decisions about potential mergers and acquisitions;
 - d) Assess compliance with the legal and regulatory requirements;
 - e) Assess the financial position and operational performance of the parent or investor; and
 - f) Assess the liquidity of an entity.
- 2.19 When one considers **separate financial statements under IFRS**, their use depends on whether or not an EU country permits or requires entities to prepare their annual financial statements in compliance with IFRS in its jurisdiction. If it does not, then the number of users and the use of separate financial statements under IFRS, which are prepared on a voluntary basis in addition to the required Local GAAP, is more limited. If separate financial statements under IFRS are not required by law for public use, then the information provided by such financial statements will not be used as a basis for the calculation of dividends, legal disputes, etc.

Questions 2.1, 2.2 and 2.3 – The use of financial statements of a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP

Q.2.1 Do you agree with the description of the use of financial statements of a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP? Please explain.

Q.2.2 Considering the wide range of users of financial statements of a legal entity identified in the Discussion Paper, do you believe that paragraphs 2.13 to 2.17 accurately identify the primary users of separate financial statements? Please explain.

Q.2.3. In your experience, are there any additional users of financial statements of a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP? If so, could you please identify the other users of such financial statements?

Information needs of users

- 2.20 Those who prepare and use financial statements of a parent or an investor have indicated that financial statements of a parent or investor should provide information about the performance, economic resources of and claims against a legal entity to help users assessing its creditworthiness, and its capability to generate cash flows to repay debt, and distribute dividends.
- 2.21 Users also highlighted the need for information about ‘off balance sheet obligations’ and about how management was using the entity’s resources. Tax and other legal authorities often turn to the financial statements as the starting point for determining taxable income and to assess compliance with regulatory requirements (e.g. capitalisation requirements). Management is responsible for knowing whether their investments are well capitalised, their financial statements comply with local statutory obligations and the entity is capable of distributing dividends.
- 2.22 Our research also revealed a common basis between the needs of users of separate and consolidated financial statements. For example, both can be used to make financing decisions (e.g. for creditworthiness).

What is missing in or should be changed to the current IFRS guidance about separate financial statements

2.23 Our research revealed that additional guidance is needed for the following major financial reporting areas:

- a) Measurement of investments in separate financial statements;
- b) Common control transactions, including the accounting treatment of business combinations under common control in separate financial statements;
- c) Disclosures under separate financial statements, including disclosures on restrictions on the ability of an entity to distribute its equity (capital maintenance); and
- d) Clarification of the current terminology under IFRS.

2.24 An explanation of these areas and our recommendations for potential solutions to these concerns are presented in the next chapter. However, before we start our analysis of the areas described above, we will first consider a fundamental question: whether or not there should be symmetry in accounting for transactions or events in the separate and consolidated financial statements.

Chapter 3: Defining and addressing the financial reporting areas related to separate financial statements

INTRODUCTION

- 3.1 This chapter considers a number of financial reporting areas identified by those applying and using separate financial statements under IFRS. Those areas have been discussed in a number of meetings with user representatives, such as the EFRAG User Panel, and directly with users, preparers and academics (see chapter 2). We have also received feedback from a number of National Standard Setters, professional associations, regulators and EFRAG TEG members.
- 3.2 Finally, this chapter considers whether there is a need for the IASB to specifically address accounting in separate financial statements, and whether there is a need to amend certain IFRS requirements.

IDENTIFIED FINANCIAL REPORTING AREAS

- 3.3 The main financial reporting areas outlined in this chapter are the following:
- a) **Measurement of investments in separate financial statements:** according to IAS 27, when an entity prepares separate financial statements, it may account for investments in subsidiaries, joint ventures and associates at cost or in accordance with IAS 39. However, IAS 27 does not provide guidance as to which costs should be reflected at initial recognition. Therefore, there are situations where it is unclear how one should account for certain transactions (e.g. transaction costs and contingent consideration). Our research also revealed that some called for the use of the equity method in the separate financial statements as they considered that the application of this method would result in decision-useful information to users of separate financial statements about the economic value of an investment. On this issue, the IASB decided in April 2014 to publish an amendment to IAS 27 to allow the use of the equity method in the separate financial statements; for this reason, it is not further analysed in this Discussion Paper. EFRAG will monitor this issue within its endorsement process of amendments to current IFRS;
 - b) **Common control transactions, including the accounting treatment of business combinations under common control in separate financial statements:** this relates to the general concern regarding common control transactions and the debate on how business combinations under common control (BCUCC) should be accounted for in the separate financial statements;
 - c) **Disclosures under separate financial statements:** the question is whether the disclosure requirements under current IFRS are sufficient from a user perspective or whether IFRS should require additional disclosures about dividends available to shareholders, taking into account any restrictions that might apply; and

- d) **Clarification of the current terminology under IFRS:** this relates to the feedback received from users, preparers, academics and public authorities that the IASB should clarify the purpose of separate financial statements and individual financial statements (as referred in IFRS), and the specific requirements applicable to each other.

3.4 Accordingly, the Discussion Paper discusses and, whenever applicable, presents possible solutions to identified problems that may have implications for the relevance of information and faithful representation of economic events that are either:

- a) Addressed under IFRS, but deemed not to provide decision useful information; or
- b) Not addressed under IFRS.

ACCOUNTING POLICIES TO BE APPLIED TO SEPARATE FINANCIAL STATEMENTS

- 3.5 In chapter 1 we have already concluded on the importance of separate financial statements and highlighted that the reason for differences in accounting treatment between separate and consolidated financial statements results from the fact that consolidated and separate financial statements reflect different views: the view of a group and the view of the legal entity.
- 3.6 The question nevertheless remains whether there is a different or modified objective for separate financial statement, and, therefore, whether the accounting policies to be applied to either set of financial statements should be identical or different.
- 3.7 In the current *Conceptual Framework*, the IASB does not identify a different or modified objective for separate financial statements, and, therefore, the overriding assumption is that the same accounting policies and basis for presentation should apply in separate and consolidated financial statements.
- 3.8 However, some argue that separate financial statements have a different informational use to that of consolidated financial statements, and that therefore, the accounting policies to be applied to either set of financial statements do not necessarily have to be the same. As separate financial statements are those that are prepared to reflect the parent as a separate legal entity, under this view the accounting policies would follow the legal form of transaction more closely than in the consolidated financial statements; for instance in the accounting for acquisition of a business and legal mergers or the application of the definition of a financial instrument under IAS 32.

- 3.9 If convincing evidence shows that the objectives of separate and consolidated financial statements are completely different, then it would make sense to use a ‘fresh start’ approach, where different objectives of financial reports, different definitions and different concepts of recognition and measurement would have to be established for separate financial statements.
- 3.10 However, we believe that this approach is not needed because the needs of users of separate financial statements can be similar to and converged with the needs of users of consolidated financial statements for most of the items presented in these statements. Therefore, the existing IFRS are the logical starting point for the preparation of separate financial statements and, consequently, the initial assumption is that like transactions and events should be accounted for and reported in the same way in separate and consolidated financial statements.
- 3.11 The next step is to determine when like transactions and events should have a differentiated accounting treatment in separate and consolidated financial statements given the particular needs and perspective of separate financial statements.
- 3.12 For example, when an entity acquires a group of assets and liabilities that constitutes a business, should such an acquisition be accounted for as a business combination in accordance with IFRS 3 (same accounting treatment as in consolidated financial statements), or should it be accounted for differently? Moreover, considering that separate financial statements are normally the basis for determining whether a company is insolvent, should IFRSs provide a different definition of equity in the separate and consolidated financial statements?
- 3.13 The issue of whether there should be differentiated accounting treatment for certain transactions and events in separate and consolidated financial statements will be considered throughout this chapter, especially when considering what changes are necessary, if any, to the current IFRS guidance on separate financial statements.

Question 3.1 – Accounting policies to be applied in separate and consolidated financial statements

Q.3.1 In which cases, if any, do you believe that the accounting policies applied to either set of financial statements should differ? Please explain.

MEASUREMENT OF INVESTMENTS IN THE SEPARATE FINANCIAL STATEMENTS

Introduction

- 3.14 According to present IAS 27, when an entity prepares separate financial statements, it shall account for investments in subsidiaries, joint ventures and associates either at cost or in accordance with IAS 39. Although both IAS 39 and IFRS 9 provide guidance on how to account for transaction costs, IAS 27 does not provide any specific guidance on the initial measurement of investments when such investments are accounted for at cost. It is therefore unclear how one should account for certain transactions or events such as ‘transaction costs’ and ‘contingent consideration’.
- 3.15 Paragraph 4.55 of the *Conceptual Framework* states that a number of different measurement bases can be employed to different degrees and in varying combinations in financial statements, and that historical cost is one of them. This paragraph further details that historical cost is a measurement base where “assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition”.
- 3.16 Standards such as IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 40 go further and provide details on the cost measurement method by:
- Defining 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, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other IFRS, e.g. IFRS 2 *Share-based Payments*;
 - Providing guidance on the elements of cost of an acquired item (IAS16.16; IAS 38.27; IAS 40.22).
- 3.17 A question is whether the lack of specific guidance in IAS 27 creates a comparability issue and whether specific guidance is needed in IAS 27 for the measurement of the investments, namely whether transaction costs should be part of the measurement of investments and how contingent consideration should be accounted for.

Accounting for transaction costs

- 3.18 Paragraph 9 of IAS 39 defines **transaction costs** as incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. It further details that an incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

3.19 In addition to the definition provided, there are a number of other references to transaction costs in IFRSs, namely:

- a) IFRS 13 *Fair Value Measurement* states that the price in the principal market used to measure the fair value of an asset or liability should not be adjusted for **transaction costs**. It further details that transaction costs shall be accounted for in accordance with other IFRSs and that transaction costs are not a characteristic of an asset or a liability; rather, they are specific to a transaction and will differ depending on how an entity enters into a transaction for the asset or liability (IFRS 13.25);
- b) IAS 40 states that an investment property shall be measured initially at its cost and that **transaction costs** shall be included in the initial measurement under the cost method (IAS 40.22). Although the standard does not define transaction costs, paragraph 21 of IAS 40 states that directly attributable expenditure, such as professional fees for legal services, property transfer taxes and other transaction costs, shall be included in the initial measurement; and
- c) Paragraph 5.11 of IFRS 9 (as of 1 January 2014) and paragraph 43 of IAS 39 (Blue book as of 1 January 2014) state that, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, **transaction costs** that are directly attributable to the acquisition or issue of the financial asset or financial liability.

It is worth noting that according to IAS 39 and IFRS 9, an entity that measures a financial asset at fair value through other comprehensive income (e.g. available-for-sale financial assets as defined in IAS 39) shall, at initial recognition, capitalise transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

3.20 A number of other standards do not refer specifically to transaction costs, but refer instead to acquisition-related costs and directly attributable costs when considering the accounting for costs that arise in addition to the purchase price. For example:

- a) IFRS 3 defines **acquisition-related costs** as those that the acquirer incurs to effect a business combination and explains that such costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. In IFRS 3, acquisition-related costs are recognised as expenses in the periods in which the costs are incurred and the services are received (IFRS 3.53); and

- b) Both IAS 16 and IAS 38 refer to **directly attributable costs** of preparing the asset for its intended use, which should be included in the initial measurement of property, plant and equipment (IAS 16.16-17).
- 3.21 The **issue** is whether transaction costs/acquisition-related costs should be considered as part of the initial measurement of investments in subsidiaries, joint venture or associates accounted for at cost, or should be expensed in the separate financial statements.
- 3.22 Taking into account the existing guidance on ‘transaction costs’ in IAS 40 and on ‘directly attributable costs in IAS 16 and IAS 38’, there is the view that **transaction costs should be part of the initial measurement of investments in subsidiaries, joint venture or associates accounted for at cost**. This view is based on the belief that acquisition-related costs are unavoidable costs and are directly attributable to the acquisition (or issue) of an investment in a subsidiary, joint venture and associate. This accounting treatment would be aligned with a large number of current IFRS requirements in regard to transaction costs.
- 3.23 In contrast, it could be argued that **transaction costs should be recognised as expenses in the periods in which the costs are incurred and the services are received**. This view is based on the idea that transaction costs should have a similar accounting treatment in both separate and consolidated financial statements when it comes to the accounting for equity investments. The reasoning for such accounting treatments is explained by the IASB in paragraph BC366 of IFRS 3, where it states that acquisition related costs are not part of the fair value exchange between the buyer and seller of the business. Rather, they are separate transactions in which the buyer pays for the fair value of services received.
- 3.24 However, such view can be disputed by the fact that in separate financial statements the focus is on investments as assets and the acquisition of an equity investment does not represent a business combination in the separate financial statements.

Accounting for contingent consideration

- 3.25 When an entity acquires an investment in a subsidiary, joint venture or associate, the acquisition agreement may include consideration that can vary depending on whether certain future events occur or conditions are met (e.g. on the purchaser’s future activity derived from the underlying asset). This consideration is often referred as variable consideration or contingent consideration.
- 3.26 As there is no specific guidance in IAS 27 for accounting for contingent consideration in separate financial statements, the **issue** is thus how to account for contingent consideration in separate financial statements.

IASB's discussions on contingent consideration

- 3.27 The issue of how to account for contingent consideration has been comprehensively discussed by the IASB in different projects such as *Revenue from Contracts with Customers*, *Leases*, *A Review of the Conceptual Framework for Financial Reporting* and *Variable payments for the separate acquisition of property, plant and equipment, and intangible assets*.
- 3.28 For example, the 2013 *Discussion Paper A Review of the Conceptual Framework for Financial Reporting* considered extensively the timing of initial recognition of the liability when accounting for contingent consideration. Particularly relevant were the IASB and IFRS Interpretations Committee discussions in March and July 2013 on the broad issue of *Variable payments for the acquisition of property, plant and equipment, and intangible assets* outside of a business combination. The IASB and IFRS Interpretations Committee discussions addressed both initial and subsequent accounting for a financial liability related to variable payments (i.e. contingent consideration).
- 3.29 Although the project is currently on hold, the IFRS Interpretations Committee tentatively agreed that:
- a) Variable payments that do not depend on the purchaser's future activity should be included in the initial measurement of the liability on the date of the purchase of the asset; and
 - b) If a financial liability is not a floating rate instrument then, in specified circumstances, the cost of the corresponding asset should be adjusted when the carrying amount of that liability is remeasured.
- 3.30 At its July 2013 meeting, the IASB noted that the initial accounting for variable payments affected their subsequent accounting. Some IASB members expressed the view that the initial and subsequent accounting for variable payments for the purchase of assets were linked and should be addressed comprehensively. The IASB also noted that accounting for variable payments was a topic that had been discussed as part of the *Leases* and *Conceptual Framework* projects. The IASB decided that it would reconsider the accounting for variable payments for the acquisition of tangible or intangible assets after the proposals in the Exposure Draft *Leases* (published in May 2013) had been redeliberated.

Accounting for contingent consideration in separate financial statements

- 3.31 When an entity prepares its separate financial statements and has to account for contingent consideration for the acquisition of a subsidiary, joint venture or associate, three issues arise:
- a) The timing of recognition of the liability;
 - b) Initial accounting for a financial liability related to variable payments; and
 - c) Whether subsequent changes to the carrying amount of the liability give rise to a change in the value of the asset or to an expense/gain.
- 3.32 As the current standard on separate financial statements does not provide guidance on contingent consideration, there is the view that **IAS 27 should specifically provide guidance on contingent consideration for the acquisition of a subsidiary, joint venture or associate**, dealing both with the initial recognition and with subsequent accounting. In particular, it should provide guidance on whether subsequent changes to the liability give rise to an expense/gain or an adjustment to the asset.
- 3.33 Considering the IASB's discussions on *Variable payments for the separate acquisition of PPE and intangible assets* and current guidance on contingent consideration in IFRS 3, there is a view that IAS 27 could be amended to state that at initial recognition an entity should recognise the acquisition-date fair value of the contingent consideration as part of the acquisition cost of the asset, when the recognition criteria in IFRS 9/IAS 39 and IAS 32 are met. If the recognition criteria according to IFRS 9/IAS 39 are not met at acquisition date but only at later date (e.g. when the corresponding activity requiring the payment is performed), then the recognition of the liability would give rise to an adjustment to the acquisition cost of the asset acquired at that later date.
- 3.34 Two possibilities arise from **subsequent adjustments** to the liability:
- a) **The recognition of an expense/gain** if the remeasurement of the liability would not be related to the purchase transaction itself and corresponds to a 'floating rate instrument' or to an 'embedded derivative that should be separated from the initial financial liability' (the cash flows are modified, for example, according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index); or
 - b) **An adjustment to the carrying amount of the asset** in all other circumstances, as the remeasurement of a financial liability would be related to the purchase transaction itself (e.g. the liability is modified according to the agreed-upon specification of an asset at specific dates in the future or according to the purchaser's future activity).

- 3.35 Alternatively, **any guidance on contingent consideration related to the acquisition of an investment could follow the current guidance in IFRS 3**. This view is based on the idea that current IFRS already provides sufficient guidance for transactions that involve contingent consideration and, therefore, IAS 27 should be aligned with IFRS 3. More particularly, at initial recognition the acquirer should always recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree. For subsequent changes in the fair value of the contingent consideration that occurred after the measurement period and are not reported in equity, an entity should account for such changes in profit or loss.
- 3.36 However, such view can be disputed by the fact that the acquisition of an equity investment does not represent a business combination in the separate financial statements and IFRS 3 clearly distinguishes business combination accounting from asset acquisition accounting.

Information needs of users about investments in subsidiaries, joint ventures and associates in separate financial statements and our tentative views

- 3.37 As noted in chapter 2, users of separate financial statements are typically focused on the economic value of the investments and on the return on such investments (e.g. dividends). This is aligned with the IASB's conclusion in paragraph BC10 of IAS 27 that **“for separate financial statements the focus is upon the performance of the assets as investments”**.
- 3.38 This means that users of separate financial statements need information that will enable them to easily relate the total amount of cash paid and/or expected to be paid for the acquisition of the investment with the future expected returns on that investment. This is particularly true when considering that investments in subsidiaries, joint ventures and associates are not usually held within the business model focused on short-term gains and losses from changes in fair value.
- 3.39 This also means that for separate financial statements the acquisition of investments should be considered an ‘asset deal’ rather than a ‘business deal’. This is an important distinction, since IFRS provides different requirements for the ‘acquisition of assets’ and the ‘acquisition of a business’.
- 3.40 **Considering this, our tentative view is that transaction/acquisition-related costs should be part of the initial measurement of investments in subsidiaries, joint venture or associates accounted for at cost.**

- 3.41 We believe that reflecting transaction costs in the measurement of the investments would have the benefit of providing useful information to users of separate financial statements about the accumulated amount of cash spent to acquire an investment at the time of its acquisition. With such information, users of separate financial statements would be in a better position to assess the performance of the investments.
- 3.42 We also believe that with such an approach, the accounting treatment of acquisition of investments would be better aligned with the accounting treatment of the other ‘asset deals’, such as in IAS 40 and IAS 16, which require or permit particular acquisition-related costs to be included in the cost of an asset acquisition.
- 3.43 Finally, we believe that such an approach would allow users to better understand how efficiently management uses the resources of the company.
- 3.44 **It is also our tentative view is that IAS 27 should specifically provide guidance on contingent consideration for the acquisition of an investment in a subsidiary, joint venture or associate, dealing both with the initial recognition and subsequent accounting, and any guidance on subsequent adjustments to the liability on IAS 27 should reflect the IASB’s discussions on variable payments for the separate acquisition of property, plant and equipment, and for intangible assets. That is, the acquisition of an investment should be accounted for as an acquisition of an asset.**
- 3.45 Such accounting treatment would also have the benefit of providing useful information to users of separate financial statements about situations where a change of the liability is related to the purchase transaction itself.
- 3.46 When looking at separate and consolidated financial statements in parallel, one may note that an ‘investment in a subsidiary’ and an ‘acquisition of a business’ incorporated in a vehicle represent, from a legal point of view, the exactly same transaction. Nonetheless, this does not mean that this ‘transaction’ should have the exactly same accounting treatment in the separate and consolidated financial statements (i.e. it does not mean that there should be symmetry), particularly when dealing with the different components embedded in the transaction (e.g. contingent consideration and transaction costs). As mentioned above, the existence of different accounting policies in separate and consolidated financial statements can be justified by the fact that consolidated and separate financial statements reflect different views: the view of a group and the view of a legal entity.
- 3.47 We also acknowledge that the differences between separate and consolidated financial statements can be magnified by the fact that IFRS requires separate accounting treatments for ‘business combinations’ and ‘asset acquisitions’. Although the objective of the discussion is not to focus on whether there are benefits of having such separate

accounting treatment, we are aware of the benefits of not applying the IFRS 3 principles in separate financial statements when accounting for the different components embedded in an investment in a subsidiary, such as contingent consideration. That is, not requiring different accounting treatments depending on whether changes in the fair value of contingent consideration occur within or after the measurement period.

Questions 3.2 and 3.3 – Accounting for transaction costs and contingent consideration

Q.3.2 Do you consider that acquisition-related costs should be expensed or should be part of the initial measurement of investments in subsidiaries, joint ventures or associates accounted for at cost in the separate financial statements? Please explain.

Q3.3 Do you consider that contingent consideration should be accounted for in accordance with IFRS 3 or should be accounted for as part of the initial and subsequent measurement of investments in subsidiaries, joint ventures or associates accounted for at cost in the separate financial statements? Please explain.

COMMON CONTROL TRANSACTIONS

Introduction

- 3.48 The notion of ‘common control transactions’ is commonly associated with transactions between entities that are ultimately controlled by the same party or parties. However, the description of ‘common control’ is not free from debate and questions have been raised on the appropriateness of the description of common control provided in IFRS 3.
- 3.49 For example, the Korean Accounting Standards Board raised questions on whether the definition of common control transactions set out in IFRS 3 was appropriate (*Transactions under Common Control*, Korea Accounting Standards Board, December 2012). Furthermore, the IFRS Interpretations Committee has considered numerous issues related to common control transactions, often declining to add those matters to its agenda, and referring them instead to the IASB for consideration as part of a comprehensive project on common control transactions.

3.50 **It is assumed in this paper, in line with the language in IFRS 3, that common control transactions are transactions between entities that are ultimately controlled by the same party or parties both before and after the transaction, and that control is not transitory.**

3.51 This means that ‘common control transactions’ is a wide notion: it includes all transactions between entities under common control and is not restricted to transactions between entities that are part of the same group (i.e. they can be with entities controlled by the same individual shareholder – paragraph B3 of IFRS 3). Examples of common control transactions include the sale of property to an entity in the same group and business combinations between two subsidiaries of the same parent.

General concerns regarding common control transactions

3.52 In a number of cases, it is reasonable to expect that the price agreed (fair value of the consideration given) in a transaction between entities under common control will not significantly differ from the market value of the assets received and liabilities assumed, given that in some countries there are fiscal and commercial provisions over such transactions in the separate financial statements.

3.53 However, entities under common control may engage in transactions that unrelated parties would not contemplate entering into. Entities under common control may also settle transactions at prices that are not at arm’s length. This means that one cannot always assume that equal values are exchanged in common control transactions (i.e. the transaction price might not represent the fair value of an asset at initial recognition).

3.54 Therefore, common control transactions may have a significant impact on the separate financial statements of an entity (i.e. the statement of comprehensive income and the statement of financial position). This results from the possible effects of non-arm’s length transactions and the fact that intragroup transactions and outstanding balances are not eliminated in the separate financial statements.

3.55 Although the same accounting principles for recognition and measurement are generally applied to both common and non-common control transactions, disclosures required by IAS 24 *Related Party Disclosures* are essential to draw attention to the possibility that an entity’s statement of financial position, statement of comprehensive income and statement of cash flows, may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

3.56 Therefore, the question is whether the current IFRS requirements need to be reconsidered when dealing with common control transactions in the separate financial statements of an entity or whether disclosures according to IAS 24 are sufficient.

- 3.57 The fundamental approach of IAS 24 is that even though the same measurement principles apply to transactions between both related and non-related parties, there could be a level of support by related parties. For example, a reporting entity may receive property, plant and equipment through its parent. Obviously, reporting that an entity acquired an asset at no cost would faithfully represent its acquisition cost, but is unlikely to faithfully represent the economic substance of the transaction, since it was not conducted at arm's length. Therefore, disclosure of such transactions is essential to achieve a faithful representation of an entity's financial position and financial performance, and to provide relevant information to its users (paragraphs BC11-17 of IAS 24).

Possible alternatives to consider when accounting for common control transactions

- 3.58 According to current accounting standards, the acquisition of a property item should initially be measured at cost. However, the usefulness of the outcome may be questioned in transactions that are not subject to market forces.
- 3.59 If a parent sells a property to its subsidiary, the transaction may have been made at a price decided by the parent that is different from the market value. Thus, from the information value point of view, an alternative to relying on disclosure requirements in IAS 24 would be to challenge the current measurement bases in IFRS and set out specific accounting requirements for common control transactions in the separate financial statements of an entity.
- 3.60 There are a number of measurement bases that could be used for initial measurement for common control transactions, which may not necessarily be the same for all types of common control transactions (e.g. purchases of tangible assets and purchase of services):
- Transaction cost approach (approach 1):** based on the view that accounting should reflect the actual terms of the transaction. The historical cost approach is one of the most commonly adopted measurement bases at initial measurement (e.g. an entity that receives an equipment through its parent, accounts for the asset at no cost);
 - Fair value approach (approach 2):** based on the view that the accounting for the transaction should be as if it had been carried out at arm's length (e.g. an entity that receives an equipment through its parent, accounts for the asset at its fair value);
or
 - Carrying amount approach (approach 3):** based on the view that, in a group transaction, the asset in the transaction has simply been moved from one part of the group to another (e.g. an entity that receives an equipment through its parent, accounts for the asset at the carrying amount in the financial statements of the parent).

- 3.61 With approaches b) and c), questions arise on how to account for any difference between the amounts recognised (or derecognised) and the amount of consideration paid (or received), and whether there is an element of capital contribution or dividend in relation to the party in control of the transaction. These considerations would be relevant for both downstream transactions (e.g. between a parent and its subsidiary) and sideways transactions (e.g. between two subsidiaries of the same parent).
- 3.62 It may also be considered appropriate to recognise a capital contribution from owners, for example, if the provision of a personal guarantee by a shareholder results in an entity paying a lower interest rate on its borrowings.
- 3.63 The above consideration is valid when there is no specific standard that requires the initial measurement of the asset acquired or liability incurred at fair value. If a standard requires transaction to be recognised initially at fair value (e.g. IAS 39/IFRS 9), it must be measured at that fair value regardless of the actual consideration.
- 3.64 It is worth noting that in 2002 the IFRS Interpretations Committee discussed whether transactions between entities under common control that are not at arm's length should be accounted for as a capital contribution from or distribution to the party having control. It did not reach a conclusion on this matter.

Sale or contribution of equity investments between entities under common control

- 3.65 IAS 27 does not deal specifically with or scopes out the accounting for transactions of equity investments (in a subsidiary, joint venture or associate) between entities under common control. Therefore, an entity would have to apply the general accounting principles in IAS 27 and IAS 24 for common control transactions. However, the usefulness of the outcome may be questioned, as these transactions are not subject to market forces. For example, if an entity sells an investment in a subsidiary to its parent, such transaction may have not been made on an arm's length basis.
- 3.66 For initial measurement of an acquisition of an equity interest the approaches referred in paragraph 3.60 could be considered by the acquirer when accounting for the equity investments acquired:
- Transaction cost approach (approach 1):** account for the investment at the amount of consideration given to acquire the equity investment at the date of acquisition (in accordance with current guidance in IAS 27);
 - Fair value approach (approach 2):** account for the investment at the fair value of the equity investment at the date of acquisition, regardless of the amount of consideration given to acquire the equity investment (in accordance with current guidance in IAS 27 and IAS 39/IFRS 9); or

c) **Carrying amount approach (approach 3)**: this approach is based on the view that the investment (if in a group) has simply been moved from one part of the group to another. In such an approach, the relevant carrying amount could be, for example:

- (i) The carrying amount in the consolidated or separate financial statements of the seller or contributor;
- (ii) The carrying amount in the consolidated or separate financial statements of ultimate parent in the group (parent of the seller or contributor); or
- (iii) The carrying amount of the net assets of the entity acquired or contributed.

3.67 With approaches b) and c), questions arise on how to account for any difference between the amounts recognised and consideration paid, and whether an element of capital contribution from and/or distribution to the party having control should be included. A few examples may clarify how to account for these differences.

3.68 Assume the following transaction between entities under common control as B and C are both controlled by A:

Example 1

3.69 Consider that Entity C acquires all the voting interests of Entity D from B and that:

- a) The fair value of the Entity D is 200;
- b) The carrying amount of Entity D in Entity B was 150; and
- c) The transaction price was 100.

3.70 According to paragraph 3.66 above, different accounting approaches could be considered:

Transaction cost approach (approach 1)

Account for the acquisition in the acquirer's separate financial statements			
Entity C	Debit	Credit	Description
Investments	100		Initial recognition at transaction cost
Cash		100	Amount paid

Fair value approach (approach 2)

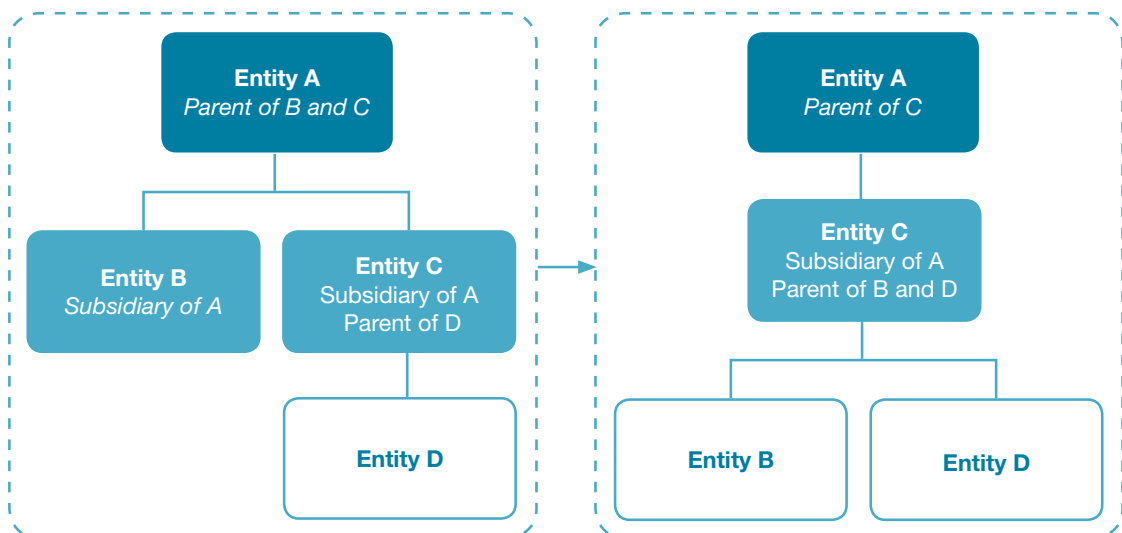
Account for the acquisition in the acquirer's separate financial statements			
Entity C	Debit	Credit	Description
Investments	200		Accounted for on fair value basis
Cash		100	Amount paid
Equity or Profit or loss		100	Contribution to equity or directly to profit or loss

Carrying amount approach (approach 3)

Account for the acquisition in the acquirer's separate financial statements			
Entity C	Debit	Credit	Description
Investments	150		Accounted for on carrying amount basis
Cash		100	Amount paid
Equity or Profit or loss		50	Contribution to equity or directly to profit or loss

Example 2

- 3.71 Consider now that Entity C has carried out a capital increase through the issue of new shares at par and that Parent A has contributed a non-monetary asset, all the shares of Entity B, in exchange for the new shares issued by Entity C.



- 3.72 According to paragraph 3.66 different accounting approaches could be considered by the Entity C (acquirer):
- Account for the investment at the amount of consideration given to acquire the equity investment at the date of the acquisition (nominal amount of the shares given), regardless of the fair value of the equity interest of Entity B;
 - Account for the investment at its acquisition-date fair value; or
 - Use the net asset carrying amount in the consolidated or separate financial statements of Entity A; or use the net asset carrying amount of Entity B from its financial statements.
- 3.73 When discussing which of the approaches should be applied to account for the transaction described above, different views arise. For example, some argue that although this transaction is out of the scope of IFRS 2 (according to paragraph 2 to 6 of IFRS 2), the transaction is quite similar to a shared-based payment transaction in which an entity receives goods or services as consideration for equity instruments. Therefore, considering the guidance in IFRS 2 by analogy, the transaction in which an investment in **Entity B** is received as a form of consideration from **Entity A** for the acquisition of equity instruments of **Entity C** should be measured at acquisition-date fair value of the investment in **Entity B** received. However, others believe that the investment has simply

been moved from one part of the group to another. Therefore, the transaction should be accounted for at the net asset carrying amount in the consolidated or separate financial statements of Entity A. Finally, others think that an entity should account for the investment at the amount of consideration given (nominal amount of the shares given) as this faithfully represents the terms of the transaction.

- 3.74 Equally, the accounting for transactions of investments (in a subsidiary, joint venture or associate) between entities under common control can vary depending on the relationship between acquirer and transferor, on the measurement used (e.g. carrying amount, fair value or settlement amount), consideration given, and form of transfer (e.g. sale, distribution of dividends, contributions). For example:
- a) A parent sells an equity investment (in a subsidiary, joint venture or associate) to a subsidiary;
 - b) A subsidiary sells an equity investment to parent;
 - c) A subsidiary sells an equity investment to another subsidiary (within the same group); and
 - d) A subsidiary transfers an equity investment to a parent by means of a dividend.
- 3.75 For these transactions, the three approaches measurement referred above could be considered by the acquirer when recognising the investment in its separate financial statements.
- 3.76 If the carrying amount or fair value approach is chosen, then the issue arises again which carrying amount should be used and how to account for the difference between the amount recognised and the transaction price (i.e. whether such difference should be considered as capital contribution/distribution).

Information needs of users about sale or contribution of investments between entities under common control and our tentative view

- 3.77 If the transaction between entities under common control lacks commercial substance (i.e. not an arm's length transaction), then the use of the cost method will not necessarily result in useful information for users of separate financial statements, even if the cost method reflects what is in the sale and purchase agreement.
- 3.78 The remaining option to account for sale or contribution of equity investments between entities under common control in accordance with IAS 27 is to account for the investments in accordance with IAS 39/IFRS 9.

- 3.79 According to paragraphs 5.1.1A and B5.1.2A of IFRS 9, if the transaction price does not represent the fair value of an asset at initial recognition (as described in paragraph B4(a) of IFRS 13), then the entity should recognise the difference between fair value and transaction price in profit or loss. Some disagree and argue that in common control transactions the difference between fair value and transaction price should be considered as a capital distribution or contribution and, therefore, be reported in equity. This view is based on paragraph 4.25(a) of the *Conceptual Framework*, that states that “income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants”. However, others argue that accounting for such a difference directly in equity may be create a conflict with legal requirements, particularly, when one considers that in certain jurisdictions the entity must be certain that a contribution or distribution really existed in legal terms.
- 3.80 Considering that users of separate financial statements need information to assess the economic resources available to repay debt and pay dividends, **our tentative view is that the use of fair value, as required by IAS 39/IFRS 9, would provide relevant information about the economic value of investments**, particularly, when the transaction price does not represent the fair value of an asset or a liability at initial recognition as described in paragraph B4 of IFRS 13.

Questions 3.4, 3.5, 3.6 and 3.7 – Sale or contribution of investments between entities under common control

Q3.4 Do you agree that the IASB needs to set out specific accounting requirements for the acquisition of investments from entities under common control in the separate financial statements? Please explain.

Q3.5 In you view, which of the approaches presented in paragraph 3.66 of the Discussion Paper provides more relevant information to users? Please explain.

Q3.6 If an entity applies the ‘fair value’ approach or ‘carrying amount’ approach (as described in paragraph 3.66 of the Discussion Paper), how should it account for any difference between the ‘transaction price’ and the amount of investment initially recognised at ‘fair value’ or ‘carrying amount’? Please explain.

Q3.7 Do you think that the use of the fair value method (i.e. the application of IAS 39/IFRS 9) is the most appropriate option to account for investments acquired by entities under common control? Please explain.

BUSINESS COMBINATIONS UNDER COMMON CONTROL IN THE SEPARATE FINANCIAL STATEMENTS (BCUCC)

Introduction

- 3.81 In October 2011, the OIC and EFRAG published the BCUCC Discussion Paper with the objective of stimulating the debate about how BCUCC should be reflected in the consolidated financial statements as BCUCC are scoped out of IFRS 3 and a number of different approaches are applied in practice. This Discussion Paper dealt with initial recognition and measurement of BCUCC transactions in the consolidated financial statements of the transferee. The Discussion Paper considered three different views or ways of looking at the problem and noted that there was no 'ideal' accounting approach.
- 3.82 Detailed discussions on separate financial statements were not included in the paper, as it was considered not feasible to adequately address all the issues in a single document at that time. However, a number of questions related to separate financial statements were included in the paper to get input for a project on separate financial statements.
- 3.83 The BCUCC Discussion Paper also noted that during EFRAG TEG discussions, it was clear that an equity interest in a subsidiary acquired by an entity under common control should be accounted for in the separate financial statements of the transferee in accordance with IAS 27. The key question was how a transferee should account for a transaction between entities under common control where the transferee receives a group of assets and liabilities that meet the definition of a business.
- 3.84 Another aspect highlighted in the BCUCC Discussion Paper was the issue of 'symmetry' in the accounting for BCUCC in the separate and consolidated financial statements. Some believed that if the objectives of the users of the separate financial statements were different from those of the users of the consolidated financial statements, then arguably 'symmetry' of accounting for a BCUCC in the separate and consolidated financial statements, upon initial recognition, might not be essential. Others believed that the objectives of the users of the separate and consolidated financial statements are the same and that symmetry of accounting was essential.

Business combinations and separate financial statements

- 3.85 To address the question of how a transferee should account for a BCUCC in the separate financial statements, first it is necessary to make clear whether or not an entity should account for an acquisition of a business as a 'business combination' in accordance with IFRS 3 in its separate financial statements (e.g. accounting for an acquisition of a group of assets that constitute a business).

- 3.86 It is worth noting that when an entity prepares separate financial statements it must apply not only IAS 27 but also all other relevant standards to the extent that they do not conflict with IAS 27. Consequently, business combination accounting (IFRS 3) may be used in the separate financial statements in certain circumstances, namely when an entity acquires **a group of assets and liabilities that constitutes a business as defined in IFRS 3 (i.e. acquisition of a business that is not in separate vehicle)**. This is because such transaction is not under the scope of IAS 27, and something defined as a ‘business combination’ should be accounted for as a business combination irrespective of the set of financial statements involved.
- 3.87 If business combination accounting (IFRS 3) may be used in the separate financial statements in certain circumstances, then the key question is how to account for the **acquisition of a group of assets and liabilities that constitute a business as defined in IFRS 3 (i.e. acquisition of a business that is not in a separate vehicle) when all of the combining entities or businesses are ultimately controlled by the same party of parties both before and after the transaction and that control is not transitory**.
- 3.88 For common control transactions where an entity acquires a group of assets and liabilities that constitute a business as defined in IFRS 3, IFRS does not provide specific guidance on how they should be accounted for.
- 3.89 In the absence of a standard or interpretation that specifically applies, paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that management shall use its judgement in developing and applying an accounting policy that results in relevant and reliable information. Arguably, this applies for BCUCC in both the separate and the consolidated financial statements when accounting for the acquisition of a group of assets that constitute a business under IFRS 3. In making that judgement, paragraph IAS 8.11 requires management to consider the applicability of the requirements in IFRS dealing with similar and related issues, and the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework*. Therefore, the following guidance may be considered by management when developing an accounting policy that results in relevant and reliable information for BCUCC (a group of net assets meeting the definition of a business) in the separate financial statements:
- a) IFRS 3 *Business Combinations*;
 - b) IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*;
 - c) IAS 27 *Separate Financial Statement*; and
 - d) IFRIC 17 *Distributions of non-cash assets to owners*.

- 3.90 Without disregarding applicability of the requirements in IFRS dealing with similar and related issues, a major consideration is to understand what users' needs are and the general principles in the *Conceptual Framework*.
- 3.91 More particularly, the issue is whether users will be best served by making a clean break with reported values of the transferor prior to the transaction (that is erasing its financial history and stepping up to fair value at the acquisition date) or, alternatively, maintain a historical trend of financial information that results from applying a predecessor basis of accounting.
- 3.92 This issue has already been comprehensively discussed in the BCUCC Discussion Paper and three views were presented:
- a) IFRS 3 can be applied by analogy;
 - b) IFRS 3 should not be applied by analogy and a predecessor basis or 'fresh start' accounting is likely to provide more relevant information; or
 - c) The recognition and measurement principles should be driven by how the transaction impacts the decisions of users – that could result in an accounting outcome consistent with (a) or (b).
- 3.93 It was noted that there was no ideal approach and that depending on what approach is applied, it was likely that some inconsistencies would remain either with the measurement of related party transactions or with the treatment of business combinations under IFRS 3.

Information needs of users about acquisition of a group of assets that constitute a business and our tentative view

- 3.94 As explained in chapter 2, separate financial statements under IFRS can be presented by a parent or investor only if local legislation permits or requires this.
- 3.95 When local legislation allows the use of IFRS in the annual accounts, separate financial statements under IFRS have a close link with local regulations and the amounts reported in such financial statements serve various purposes, some of which are different from consolidated accounts. For example, in many cases separate financial statements will be used as a basis for the calculation of dividends, legal disputes or the determination of income taxes.
- 3.96 As presented in chapter 2, debt providers and other creditors need information about the economic resources of and the claims against a legal entity to assess its creditworthiness. The legal entity often offers no safeguards to third parties beyond the amounts of its net assets, particularly when it concerns companies with limited liability.

- 3.97 **Our tentative view is that the issues raised in the BCUCC Discussion Paper are also applicable to separate financial statements; that the recognition and measurement principles should be driven by how the transaction impacts the decisions of users; and that the accounting of BCUCC in separate financial statements depends on the facts and circumstances of each transaction. Therefore, different methods such as ‘acquisition method’, ‘pooling of interest method’ or ‘fresh start’ method may provide useful information to users, depending on the facts and circumstances.**
- 3.98 For example, if the transaction has commercial substance (i.e. parties have used an arm’s length transaction price as a reference) the acquisition method, where the assets acquired and liabilities assumed are recognised at fair value, can provide useful information to the users of separate financial statements about the recoverability of its assets and settlement of its liabilities. However, the use of the predecessor amounts of the assets and liabilities recognised in the separate financial statements of the acquiree also has its merits: such an approach would be simpler and less costly to apply; the users of separate financial statements would be able to continue to assess the financial performance of an entity based on historical trend analysis; and it would reflect the view that the ownership within a group has simply been moved from one part of the group to another (no significant incremental value of the group).
- 3.99 We acknowledge that for some the ‘acquisition of the investment in a subsidiary’ and the ‘acquisition of a group of assets and liabilities that constitutes a business’ is, in substance, the same economic event, despite the difference in legal form. Therefore, our tentative view is not unaware of the fact that the final accounting treatment of the acquisition of a business will depend, when preparing separate financial statements, on the legal form of the transaction. However, as noted in paragraph 3.8 above, separate financial statements are those that are prepared to reflect the parent as a separate legal entity and therefore, should follow the legal form of the transaction more closely than consolidated financial statements.
- 3.100 When looking at separate and consolidated financial statements in parallel, we also acknowledge that, as a consequence of following the legal form, the accounting treatment of an ‘acquisition of a group of assets and liabilities that constitute a business’ will be the same in the separate and the consolidated financial statements. That is, there will be a clear symmetry between separate and consolidated financial statements. Notably, such symmetry could only be avoided if the ‘acquisition of a group of assets and liabilities that constitute a business’ was accounted for, in the separate financial statements, as an ‘acquisition of a group of assets and liabilities in accordance with paragraph 2(b) of IFRS 3’. However, such accounting treatment would raise a number of questions. For example, in case the consideration paid does not equal the fair value of the assets and liabilities included in the business acquired, how should such difference be accounted for? As goodwill? As a gain or loss? Allocated to the individual acquired assets and liabilities assumed?

Question 3.8 – Business combinations and separate financial statements

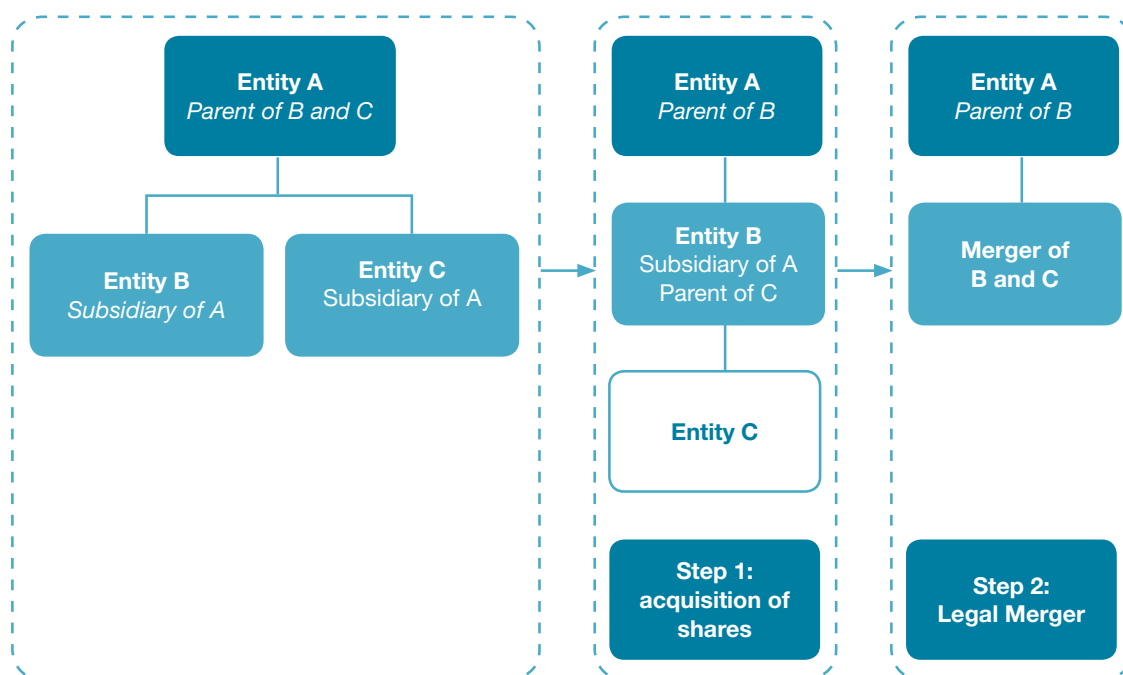
Q.3.8. In your view, what is the most appropriate approach to account for a business combination between entities under common control in the separate financial statements? Please explain.

Group reorganisations: legal mergers

- 3.101 Entities within the same group often enter into intra-group transactions, such as business combinations and mergers, to reorganise the structure of a group.
- 3.102 For example, the ultimate parent may want to merge **two subsidiaries** or merge an **intermediate parent with its subsidiary** to facilitate an IPO, to achieve tax benefits or to simplify the structure of the group.
- 3.103 A legal merger is a legal course of action where two or more legal entities are merged into one legal entity. For the sake of simplicity, we assume on this Discussion Paper that only two entities are involved. These mergers are typically structured through:
- The combination of two legal entities into one entity. In such situations, one of the legal entities ceases to exist as a separate legal entity and the survivor ‘absorbs’ all of the assets, liabilities and activities of the entity that ceased to exist; or
 - The creation of a new company (a ‘Newco’) in which the two legal entities are merged.
- 3.104 Although ‘true mergers’ or ‘mergers of equals’ are discussed in IFRS 3, where they are classified as business combinations, mergers of entities under common control are out of the scope of IFRS 3. In the absence of explicit guidance and considering that the financial statements of the legal entities involved in the merger can be significantly impacted, the issue is how to account for legal mergers between entities under common control in the separate financial statements of the acquirer, i.e. the surviving entity or the Newco.
- 3.105 One could argue that even if the original acquisition of the shares and the legal merger occur simultaneously (mergers may occur one or two years after the acquisition due to legal proceedings), there are always two steps involved:
- Step 1:** the ‘acquisition’ of the shares of the disappearing company by the surviving entity or Newco (e.g. cash-settled acquisitions, contribution of non-monetary assets for the acquisition of shares, transfer of the shares through distribution of dividend, etc.); and

- b) **Step 2:** the ‘transfer’ of the assets, liabilities and activities of the disappearing company to the surviving entity or Newco.

3.106 Nonetheless, when an entity is acquired (acquisition of shares) and then the merger occurs, the accounting treatment of the merger should be the same, regardless of whether the merger is completed in a single step or two steps.



3.107 This means that, at the time of the legal merger, the surviving company or Newco (Entity B) already has an investment in the disappearing company (Entity C) in its separate financial statements.

3.108 Under this view, the discussion on **Step 1** (i.e. the acquisition of shares in separate financial statements of Entity B) is no different from what has been discussed earlier in this chapter in paragraphs 3.65–3.76. That is, the discussion about how to account for a sale or contribution of investments between entities under common control in separate financial statements also applies to **Step 1** referred above: shall an entity initially measure such assets at cost, fair value or at a carrying amount?

3.109 In regard to **Step 2** (the transfer of the assets), a possible approach for the accounting of the legal merger is to allow the **new parent (Entity B) to recognise in its separate financial statements the carrying amounts in its consolidated financial statements as of the date of the legal merger (not of the date of acquisition)**. If we follow the example above and assume that Entity B applies the acquisition method in **Step 1** in its consolidated financial statements (Entity B as a parent), then the carrying amounts transferred to the separate financial statements of Entity B would include the assets acquired, the liabilities assumed in the business combination together with any remaining goodwill.

3.110 As consolidated financial statements reflect the view of the parent and its subsidiary as a *single economic entity*, it can be argued that the use of **the carrying amounts in the consolidated financial statements of the new parent (Entity B) as of the date of the legal merger** is the most appropriate accounting policy to be used by the new parent (Entity B). With this approach, the assets and liabilities that already existed in the acquirer's separate financial statements would continue to be recognised at the same carrying amount (apart from, of course, the investment in entity C). In addition, the acquirer (Entity B) would recognise in its separate financial statements the assets acquired and liabilities assumed at the carrying amounts in its consolidated financial statements as of the date of the legal merger. The difference between the carrying amount of the investment in the former subsidiary and the carrying amount of the assets and liabilities assumed would be recognised in equity or profit or loss. Some argue that such difference could also be accounted for as goodwill.

3.111 If we take the example of the merger of two subsidiaries:

- a) In **Step 1**, Entity B (the new parent of Entity C) would be identified as the acquirer and would prepare consolidated financial statements reflecting the business combination; and
- b) In **Step 2**, Entity B would, with the legal merger, recognise in its separate financial statements the assets acquired and liabilities assumed at the carrying amount in its consolidated financial statements (prepared in Step 1). If the legal merger between entity B and C occurs some time after the date of acquisition, then there is the issue of to how to account for difference between the carrying amount of the derecognised investment in the former subsidiary and the carrying amount of the assets and liabilities assumed, including goodwill.

3.112 Nonetheless, such an approach is not free from the practical difficulties (some already exist from the application of IFRS 3). For example, practical difficulties in:

- a) Identifying the acquirer, particularly in circumstances where the merger is between two subsidiaries and the merged entities are of approximately equal size;
- b) Determining the date of acquisition and of the legal merger, particularly in circumstances where it is difficult to assess who obtains control of the other. In such cases, should an entity consider, for example, the beginning of the year of the legal merger as a reference for determining the accounting effects of the legal merger;
- c) Deciding whether the acquirer should recognise in its separate financial statements, for practical reasons, the carrying amounts in the consolidated financial statements of the ultimate parent (Entity A) if, for example, the acquirer (Entity B) has not yet prepared consolidated financial statements after the acquisition of control (of entity C) or is not required to prepare it in accordance with paragraph 4 of IFRS 10; and

- d) Accounting for the difference between the carrying amount of the investment in the former subsidiary and the carrying amount of the assets and liabilities assumed. That is, should such difference be accounted for in profit or loss or in equity?

3.113 As IFRS 3 does not provide specific guidance on how common control transactions should be accounted for, the following alternative views could also be considered by the acquirer (entity B) that prepares separate financial statements:

- a) **The assets and liabilities of both entities (Entity B and Entity C) are carried forward at their pre-combination carrying amount values presented in their separate financial statements.** This approach is based on the view that the assets and liabilities to be included in the acquirer's separate financial statements should be exactly the same immediately before and after the reorganisation. Consequently, no additional assets or liabilities should be recognised as a result of the merger. Any difference between the amount recorded as investment in the former subsidiary and the carrying amount of the assets and liabilities assumed should be recognised in equity. Some argue that such difference could also be accounted for as goodwill;
- b) **All assets and liabilities recognised in the separate financial statements of the combining parties (Entity B and Entity C) would initially be measured at fair value.** Under this approach, none of the combining entities are viewed as having survived the combination as an independent reporting entity. Rather, the combination is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them, and the history of that new entity, by definition, begins with the combination. It would also trigger the recognition of new intangible assets; and
- c) **The investment in the subsidiary (Entity C) is first remeasured to fair value as of the date of the legal merger, with any resulting gain recognised in profit or loss.** The investment in the subsidiary is then derecognised against the acquired assets and assumed liabilities recognised at merger-date fair values. Any difference would be accounted for as goodwill or income.

Information needs of users about legal mergers and our tentative view

3.114 Creditors having claims on the merging companies have a special interest on the outcome of the legal merger. More specifically, creditors are usually concerned about whether a legal merger will adversely affect their interests. Equity investors have also a special interest on the outcome of a legal merger as they want to ensure that their current rights will be suitably protected.

- 3.115 As consolidated financial statements already reflect the view of the parent and its subsidiary as a *single economic entity*, it can be argued that the use of the carrying amounts in the consolidated financial statements as of the date of the legal merger (as described in paragraphs 3.109 above) is the most appropriate approach to account for a legal merger in the separate financial statements of the surviving entity or Newco. However, if such an approach is to be applied, this would mean that assets such as goodwill, brand names, patents or customer relationships (which the acquiree did not recognise as assets in its separate financial statements) would have to be recognised in the acquirer's separate financial statements.
- 3.116 As lenders (and other creditors) often use separate financial statements to make decisions on lending and/or the extension of credit, lenders would have to re-assess the liquidity and solvency of the combined entity after each merger. Items such as goodwill and other intangible assets referred to in the previous paragraph would have to be considered by the lenders when assessing an entity's creditworthiness, even if such intangible assets are not separable from the acquiree (now integrated in the company) or the sale of such items is infrequent. In addition, wherever the merger is between two entities without any previous control relationship (e.g. the merger of two subsidiaries), this approach may be costly to apply as the acquirer might need to engage external valuation experts.
- 3.117 A possible alternative is to account for the legal merger in the separate financial statements on the basis of the pre-combination carrying amount values presented in the separate financial statements of the merged entities (as described in paragraph 3.113a) above). This approach would be based on the view that legal mergers among group entities are characterised as a 'transfer' of a business (e.g. to facilitate an IPO, to achieve tax benefits or to simplify the structure of the group) rather than the 'acquisition' of a business. This approach would have the benefit of allowing users to continue to assess the financial performance of an entity based on historical trend analysis.
- 3.118 Another possible alternative is to consider that none of the combining entities is viewed as having survived the combination (as described in paragraph 3.113b) above). The merger is viewed as the transfer of the net assets of the combining entities to a new entity that assumes control over them. This approach would have the benefit of providing users the view of a new entity which begins with the combination. However, it is questionable whether or not the costs to the preparer would exceed the benefits to users, particularly when considering that such approach could result in the recognition of some assets and liabilities that had not been previously recognised as assets and liabilities in the financial statements of both entities.
- 3.119 **Our tentative view is that both the approaches described in paragraph 3.109 (use of the carrying amounts in the consolidated financial statements) and paragraph 3.111.a) (use of the carrying amounts in the separate financial statements of the acquiree) can provide decision useful information to users.**

3.120 As explained in paragraph 3.115 above, the use of the carrying amounts in the consolidated financial statements as of the date of the legal merger seems to be the most appropriate approach to account for a legal merger as consolidated financial statements already reflect the view of the parent and its subsidiary as a single economic entity. However, it is worth to note that the use of the carrying amounts of the assets and liabilities recognised in the separate financial statements of the acquiree also has its merits: such an approach would be simpler and less costly to apply, and the users of separate financial statements would be able to continue to assess the financial performance of an entity based on historical trend analysis.

Questions 3.9 and 3.10 – Legal Mergers

Q.3.9. Do you agree that both the approaches described in paragraph 3.109 (use of the carrying amounts in the consolidated financial statements) and paragraph 3.111.a) (use of the carrying amounts in the separate financial statements of the acquiree) can provide decision useful information to users of separate financial statements? Please explain.

Q3.10 In your view, which of the approaches described above provides, when applied in practice, more relevant information to users? Please explain.

DISCLOSURES ON DISTRIBUTIONS TO EQUITY HOLDERS IN THE SEPARATE FINANCIAL STATEMENTS

Introduction

3.121 Both the European National Standard Setters and users have expressed concerns about certain disclosure requirements under separate financial statements. Users indicated that they would welcome more detailed disclosures about distributable dividends and some members of the EFRAG User Panel thought that financial statements often failed to provide enough information to determine the maximum dividend that could be distributed. Some believed that the project should include detailed discussions about a company's ability (e.g. due to legal requirements or bank covenants) to distribute dividends.

Disclosures on distributable profits and dividends in the separate financial statements

3.122 The *Conceptual Framework* (CF.OB3) highlights that decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, such as dividends expected on the shares.

3.123 In regard to disclosures related directly or indirectly to dividends, IFRS requires the following:

- a) **Information about issued share capital and reserves:** paragraph 79(a)(v) of IAS 1 requires an entity to disclose the rights, preferences and restrictions attaching to each class of share capital, including restrictions on the distribution of dividends and the repayment of capital. In addition, paragraph 79(b) also requires a description of the nature and purpose of each reserve within equity;
- b) **Information about distributions to owners in the statement of changes in equity:** paragraph 106(a) of IAS 1 requires an entity to present a statement of changes in equity as a separate component of the financial statements and to show, among others, the total comprehensive income for the period, showing separately amounts attributable to owners of the parent and to non-controlling interests, and transactions with owners.
An entity is also required, according to paragraph 106(d)(iii) of IAS 1, to show separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.
Finally, an entity is required, according to paragraph 107 of IAS 1, to disclose the amount of dividends recognised as distributions to owners during the period and the related amount of dividends per share shall be presented on the face of the statement of changes in equity or in the notes;
- c) **Capital management disclosures:** paragraphs 134-136 of IAS 1 require an entity to disclose information about its objectives, policies and processes for managing capital (e.g. the nature of externally imposed capital requirements and how those requirements are incorporated into the management of capital), and to disclose quantitative data about what the entity regards as capital and whether the entity has complied with any external capital requirements (see the illustrative examples in paragraphs IG10 and IG11 of IAS 1);
- d) **Disclosure of the amount of dividends proposed or declared before the financial statements were authorised for issue:** According to paragraph 137 of IAS 1, an entity is required to disclose the amount of dividends proposed or declared before the financial statements are authorised for issue, but not recognised as a distribution to owners during the period, and the related amount per share; and the amount of any cumulative preference dividends not recognised; and
- e) **Disclosure of cash (and equivalents) that are not available for use by the group:** paragraphs 48 and 49 of IAS 7 require disclosures about “cash and cash equivalent balances held by the entity that are not available for use by the group”. Examples include cash held by a subsidiary that operates in a country where exchange controls or other legal restriction apply when the balances are not available for general use by the parent or other subsidiaries.

3.124 The requirements referred to above apply equally to all entities, including those that present consolidated and separate financial statements.

Separate component of equity

3.125 A number of IFRSs specify which items of income and expense (if any) should be presented as items of OCI and which of those should be **reclassified** to profit or loss. Such reclassifications are defined as ‘reclassification adjustments’ in IFRS and arise, for example, on disposal of a foreign operation (see IAS 21) and when a hedged forecast cash flow affects profit or loss (see paragraph 100 of IAS 39).

3.126 However, those standards that require amounts previously recognised in OCI to be reclassified (recycled) to profit or loss do not always require the cumulative amount of gains or losses recognised in OCI to be presented in a separate component of equity. For example, both IAS 39 and IFRS 9 are silent on whether accumulated fair value gains or losses recognised in OCI in previous periods (e.g. for financial instruments measured at fair value through OCI) should be recognised in a separate component of equity until reclassified.

Information needs of users about distributable dividends and our tentative view

3.127 The **issue** is whether disclosure requirements under current IFRS are sufficient from a user perspective or whether IFRS should require additional disclosures in separate financial statements about distributable dividends, namely the company’s ability to distribute dividends taking into account externally imposed capital requirements such as bank covenants and legal requirements (e.g. the creation of reserves required by company or other law).

3.128 Entities often present information about distributable dividends outside the financial statement and outside of the IFRS scope. However, the information provided by the legal entities can significantly differ, depending on local legal requirements.

3.129 As noted in paragraph 3.121 above, our research revealed that users indicated that they would welcome more detailed disclosures about distributable dividends and that financial statements often failed to provide enough information to determine the maximum dividend that could be distributed.

3.130 To address user’s needs, it could be argued that IAS 1 could be improved to:

- a) Require additional disclosures about:
 - (i) The impact of externally imposed capital requirements (e.g. those resulting from borrowing arrangements, legal/regulatory requirements or contractual arrangements) or the existence of any other restriction (e.g. solvency test, cash flow test, undistributable reserves etc.) on the entity’s ability to transfer, in practice, funds to its shareholders in the form of cash dividends;

- (ii) How much of an entity's income is to be allocated to the creation or increase of any type of reserves in order to comply with externally imposed capital requirements (e.g. amounts allocated to statutory reserves or to cover losses from previous years); and
 - (iii) An entity's total amount of income and reserves which are, legally, available to be distributed; and
- b) Require the presentation, in all cases, of line items in the statement of financial position reflecting accumulated amounts that may or not be recycled to profit or loss.

3.131 This information is relevant for users of separate financial statements to understand the entity's ability to pay dividends and to assess the appropriateness of an entity's dividend pay-out ratio.

Questions 3.11 and 3.12 – Disclosures about Distributions to Equity Holders

Q.3.11 Do you think that additional disclosures about distributable dividends are necessary in the separate financial statements? Please explain.

Q3.12 Do you think that all the cumulative amounts of gains or losses recognised in Other Comprehensive Income ('OCI') that will be reclassified (recycled) to profit or loss should be always presented in the statement of financial position as a separate component of equity? Please explain.

CLARIFICATION OF THE CURRENT TERMINOLOGY UNDER IFRS

Different sets of financial statements as outlined in IFRS

- 3.132 Currently IFRS defines two different sets of financial statements: **consolidated financial statements and separate financial statements (paragraph 4 of IAS 27)**.
- 3.133 In addition, IAS 27 refers to "financial statements in which investments in associates or joint ventures are accounted for using the equity method" and clarifies that such financial statements are not separate financial statements.
- 3.134 Finally, as noted in paragraph 1.8 above, the term 'individual financial statements' is not defined in IFRS, even though it is mentioned in IAS 21 (paragraphs 32 and 33), IAS 32 (paragraph AG29A), IAS 39 (paragraphs 73 and 80) and IAS 40 (paragraph 15).

Dealing with the different terms used in practice

- 3.135 Our research revealed that many National Standard Setters and preparers thought that IAS 27 does not clearly explain the objective of separate financial statements and does not draw a distinction between ‘separate financial statements’ and other financial statements such as ‘individual financial statements’.
- 3.136 For instance, some of the respondents that participated in the survey on the current use of separate financial statements in Europe (November 2011 to February 2012) raised concerns about the different terms used in IFRS. One respondent stated that the purpose and specific requirements applicable to individual financial statements and separate financial statements should be clarified. This respondent had noted some inconsistencies when reading financial statements of listed companies applying IFRS, since some of the companies misused the terms separate and individual financial statements. This respondent also thought that IAS 27 should be improved in order to be more precise with respect to its purpose towards the user’s needs. One other respondent thought that for those who prepared financial statements in accordance with IFRS it was unclear, in some circumstances, whether the non-consolidated financial statements of an investor were deemed to be ‘separate financial statements’ or ‘individual financial statements’.
- 3.137 Also some of the users, preparers and academics which were involved in EFRAG’s consultation highlighted that IFRS guidance was not clear when referring to separate and individual financial statements. In addition, respondents noted that according to IAS 27, an entity which prepared “financial statements in which investments in associates or joint ventures were accounted for using the equity method” could prepare an additional set of financial statements: separate financial statements. In their view, that was unreasonable. It was also noted that although IFRS 11 required a joint operator to account for its interest in a joint operation in its separate financial statements in accordance with the paragraphs 20-22 of IFRS 11, the standard was not clear whether an entity should present separate financial statements because of its status of being a joint operator or being a parent or investor.

Information needs of users about the different terms used in practice and our tentative view

- 3.138 In our view, the lack of clarity of the standards will, indirectly, affect users of separate financial statements, as it will not be readily understandable for the user which financial statements a reporting entity is referring to and what each set of financial statements try to portray.

3.139 Therefore, it is our tentative view that the IFRS could be improved to:

- a) **Clearly define the different types of financial statements under IFRS with the objective of enhancing the usefulness of financial information provided to users and avoid any diversity in practice** (see Appendix 2 – Defined Terms);
- b) **Clarify the objective of separate financial statements so as to provide a more robust basis when difficulties of application of IFRS to separate financial statements arise in practice** (see chapter 1 and 2 of the Discussion Paper); and
- c) **Consider the usefulness of the guidance provided in IAS 27, which allows the presentation of separate financial statements in addition to financial statements of an investor that does not have subsidiaries and where the investments are accounted for under IAS 28.** If both financial statements focus on the performance and return of an entity's investments, then such entity should be allowed to prepare only one set of financial statements.

Question 3.13 – Clarification of the current terminology under IFRS

Q.3.13 Do you agree with our tentative view as described in paragraph 3.139 above? Please explain.

OTHER COMMENTS

3.140 In this Discussion Paper we have considered a number of financial reporting areas identified by those applying and using separate financial statements under IFRS. Those areas have been discussed in a number of meetings with user representatives, such as the EFRAG User Panel, and directly with users, preparers and academics.

3.141 However, we acknowledge there are a number of other financial reporting areas related to separate financial statements which have not been addressed. For example, a number of issues have been recently discussed by the IASB within its project on the use of the equity method in separate financial statements. Those issues have not been addressed in this Discussion Paper as they were already included in EFRAG's Comment Letter to the IASB on the use of equity method in separate financial statements which has been published on 11 February 2014.

Questions 3.14 and 3.15 – Other issues

Q.3.14 Do you think there are any other significant issues regarding separate financial statements under IFRS which have not been addressed in this paper? Please explain.

Q3.15 Do you have any other comments related to separate financial statements?

Appendix 1 – Applying IFRS to annual accounts

European companies listed in an EU securities market, including banks and insurance companies

Country	Permit IAS in the annual accounts	Requires IAS in the annual accounts
Austria	No	No
Belgium	No	Yes, but only for closed ended real estate funds
Bulgaria	No	Yes, with exceptions
Croatia	No	Yes
Cyprus	No	Yes
Czech Republic	No	Yes
Denmark	Yes, for non-financial companies only	Yes, for non financial sector (when no consolidated accounts)
Estonia	No	Yes
Finland	Yes, except insurance companies	No
France	No	No
Germany	Only in addition to financial statements prepared under national GAAP	No
Greece	No	Yes
Hungary	No	No
Ireland	Yes	No
Italy	No	Yes, listed insurance companies must comply with IAS only if they do not prepare consolidated accounts
Latvia	No	Yes, for undertaking listed on the Baltic Main List
Lithuania	No	Yes
Luxemburg	Yes	No
Malta	No	Yes
Netherlands	Yes	No
Poland	Yes	No
Portugal	Yes	Yes if the statutory accounts are the only accounts that they published to the market. For the financial sector when the local GAAP are used, reconciliation with IFRS required
Romania	No	Yes, for some
Slovakia	Yes	No
Slovenia	Yes	No
Spain	No	No
Sweden	No	No
UK	Yes	No
Iceland	Yes, for the years 2005 and 2006	Yes, from 2007
Liechtenstein	Yes	No
Norway	Yes	Yes, required for listed companies that do not prepare consolidated accounts from the financial year starting after 1 January 2011

Unlisted companies

Permit IAS in the annual accounts for other companies	Require IAS in the annual accounts for other companies
No	No
No	Yes, for closed ended real estate funds
Yes	Yes
No	Yes, for large undertakings
No	Yes
Yes, when consolidated financial statements are prepared under IFRS	No
Yes, for non-financial sector	No
Yes	Yes, for financial sector
Yes, when mandatory audit	No
No	No
Only in addition to financial statements prepared under national GAAP	No
Yes, when mandatory audit	Yes, for financial sector except insurance
No	No
Yes, with exceptions	No
Yes, except for SMEs who can prepare abridged accounts	Yes, for all when companies have financial instruments widely distributed among the public (except insurance) and for supervised companies from financial sector (except insurance)
No	Yes, for financial sector
Yes, for non-financial sector	Yes for financial sector except insurance companies
Yes	No
Yes	Yes, for financial sector, for the non-financial sector, for some regulated entities and for undertakings of a certain size
Yes, except when consolidated financial statements are prepared under national law	No
Yes, for companies having filed for admission to public trading and for any parent company being a subsidiary of another parent undertaking preparing consolidated under IFRS	No
Yes, for insurance when no consolidated accounts, and for companies of non-financial sector when consolidated statements are prepared under IFRS	No
No	Yes, for credit institutions
Yes for banks, and for companies of other sectors when security issuers, payment institutions, electronic institutions, security traders.	Yes, for banks and other financial institutions; for insurance and for non-financial sector for public interest entities only
Yes, for minimum 5 years	Yes, for financial sector
No	No
No	No
Yes, except charity	No
Yes for medium sized and big companies from 2005	No. If the consolidated groups are permitted to use IAS in their consolidated accounts the annual accounts of each subsidiary are required to use IAS from 2007
Yes, all types	No
Yes, all types	No

Appendix 2 – Defined terms

A2.1 We consider the definitions according to the latest published IFRSs, including non-endorsed standards.

Group

A2.2 A group is a parent and its subsidiaries (IFRS 10: Appendix A).

Parent

A2.3 A parent is an entity that controls one or more entities (IFRS 10: Appendix A).

Subsidiary

A2.4 A subsidiary is an entity that is controlled by another entity (IFRS 10: Appendix A).

Joint venture

A2.5 A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement (IAS 28.3).

Associate

A2.6 An associate is an entity over which the investor has significant influence (IAS 28.3).

Intragroup transactions

A2.7 Intragroup transactions are transactions between a parent and its subsidiaries, or between two of those subsidiaries.

Investor-investee transactions


A2.8 Investor-investee transactions are transactions between an investor, with joint control of or significant influence over its investees, and such investees.

Consolidated financial statements

A2.9 Consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity (IFRS 10: Appendix A).

Separate financial statements

A2.10 Separate financial statements are those presented by a parent or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with IAS 39/IFRS 9 (IAS 27, paragraph 4).

- 
- A2.11 Separate financial statements may be presented in addition to consolidated financial statements or financial statements in which investments in associates or joint ventures are accounted for using the equity method (IAS 27, paragraph 6)
- A2.12 However entities may, under certain circumstances, present separate financial statements as their only financial statements (IAS 27, paragraph 8).
- A2.13 Financial statements in which investments in associates or joint ventures are accounted for using the equity method are those presented by an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for using the equity method (IAS 27, paragraph 6).

Individual financial statements

- A2.14 Individual financial statements are those presented by an entity that is neither a parent nor an investor with joint control of, or significant influence over, an investee (this term is not defined under IFRS).

Annual accounts

- A2.15 Annual accounts refer to the financial statements which are presented at the end of a financial year by a legal reporting entity, as described in the EU accounting directives (Fourth Council Directive).
- A2.16 The financial reporting landscape in Europe is complex and there is a lack of definitions and common terms between IFRS and EU accounting legislation, which often leads to a misunderstanding of terms such as ‘annual accounts’, ‘separate financial statements’ and ‘individual financial statements’. EU accounting legislation does not use the terms separate financial statements or individual financial statements. ‘Annual accounts’ is a term exclusively used under the European directives.

Appendix 3 – Further information about our research activities

A3.1 Further results of the research activities are summarised in this Appendix. The term ‘financial statements’ always refers to ‘separate financial statements’.

Research activities

A3.2 EFRAG and its partners undertook the following activities to collect data through:

- a) A review of the existing literature on the subject;
- b) A survey of the current use of separate financial statements in Europe (November 2011 to February 2012);
- c) A consultation with users, preparers and academics;
- d) Meetings with users’ representative groups; and
- e) Meetings with financial reporting experts.

Review of the existing literature on the subject

A3.3 As a starting point it was important to identify any existing literature on separate financial statements in order to understand the information previously gathered on this topic. This also helped determine the need for further investigation.

A3.4 EFRAG and its partners made an extensive analysis of the existing literature related to the usefulness of separate financial statements and financial reporting issues that arise in practice. The analysis focused on:

- a) Academic literature, including *The use of Information by Capital Providers – Academic literature review* published by EFRAG/ICAS in December 2013;
- b) The IFRS literature published by accounting firms and consulting service companies, such as accounting manuals, updates and comment letters;
- c) The documents issued by the IASB such as IFRS Interpretations Committee updates, the IASB Discussion paper *Preliminary views on an improved Conceptual Framework for Financial Reporting* (2008), IASB staff papers and various documents used by the IASB in its meetings such as comment letter analysis; and
- d) The FASB Discussion Paper *Private company decision-making framework* (2012).

Survey of the current use of separate financial statements in Europe

A3.5 In November 2011, EFRAG and its partners launched a survey among European National Standard Setters on the current use of separate financial statements in Europe to understand who prepares and who uses them and for what purposes. The survey also intended to identify any concerns with IFRS requirements when they are applied to separate financial statements.

A3.6 The survey was sent to the 27 EU Member States, Iceland, Liechtenstein, Norway and Switzerland. The survey was also made available to the Swiss Accounting Standard Setter (FER).

A3.7 We received completed surveys from 21 countries:

Austria	Ireland	Portugal
Bulgaria	Italy	Romania
Denmark	Latvia	Slovenia
Estonia	Lithuania	Spain
Finland	Malta	Sweden
Germany	Netherlands	Switzerland
Greece	Poland	United Kingdom

A3.8 In some cases EFRAG organised a follow-up contact to obtain further details or clarify answers provided.

Consultation with users, preparers and academics

A3.9 In 2013, EFRAG and its partners contacted a number of users, preparers and academics focusing on individuals with extensive knowledge of and experience with separate financial statements: for example, buy-side financial analysts, credit analysts, preparers involved in working with capital providers, market regulators, academics and providers of audit and consulting services.

A3.10 The consultation involved a questionnaire and, whenever possible, a follow-up phone interview. All interviews were based on the set of questions included in the questionnaire, and then followed up with individually tailored questions to clarify answers provided in writing. The responses to the questionnaire and the additional information received during the follow-up interviews have been used for the analysis presented in the next section called 'our research results'.

A3.11 EFRAG and its partners contacted eleven individuals and grouped them into the following categories:

<p>Users</p>	<p>Five users filled in the questionnaire. Only four of them were available for a follow-up interview: two financial analysts, one credit analyst and a provider of auditing and consulting services. One financial supervision authority provided written input only by filling in the questionnaire.</p>
<p>Preparers</p>	<p>Four preparers filled in the questionnaire and were available for a follow-up interview. All of them belonged to different industries, among which the banking and the utilities industry.</p>
<p>Academics</p>	<p>Two academics filled the questionnaire and were available for a follow-up interview.</p>

Meetings with users' representative groups

A3.12 As users play a fundamental role in the development of high-quality IFRS, the EFRAG User Panel was consulted on several occasions during the research phase of the Discussion Paper.

A3.13 The EFRAG User Panel members were consulted with the objective of understanding whether they used separate financial statements, and if so, for what purposes. They were also asked who they considered as the primary users of separate financial statements. The EFRAG User Panel members were also asked about the information needs of the primary users, and how these financial statements were currently used.

Meetings with financial reporting experts

A3.14 The EFRAG staff met regularly with several financial reporting experts: the Project Partners, the EFRAG Technical Expert Group ('TEG'); and the EFRAG Consultative Forum of Standard Setters ('CFSS'). The purpose of these meetings was to ask for input on the purpose and direction of the project, and to hold more comprehensive discussions on the outcome of the research activities and the potential solutions to the identified issues.

Appendix 4 – Further information about our research results

- A4.1 Further results of the research activities are summarised in this Appendix. The term ‘financial statements’ always refers to ‘separate financial statements’.

Information that is most useful to users

- A4.2 Our research revealed a wide range of users of financial statements of a parent or an investor regardless of whether they are prepared under IFRS or Local GAAP, particularly when such financial statements play a legal role.
- A4.3 Both the ‘information needs of users’ and the ‘frequency of use’ of such financial statements essentially depend on the type of users. Our research showed that some users rarely used them while others used them frequently, particularly when they had a legal role. Some users only looked for very specific information (e.g. distributable dividends), while others examined the financial statements comprehensively. For example, those who provide loans and other forms of credit, and those who need to make a credit assessment, often use comprehensively the information available in those financial statements. This is due to the fact that, when credit is granted to a legal entity, the users need to understand the assets and liabilities of the entity, as it will give them information about their exposure to risk. However, equity investors do not frequently use those financial statements, even though some of their components are used to supplement the information found in the consolidated financial statements.
- A4.4 It is worth noting that when assessing who the primary users of the financial statements of a parent or an investor (under IFRS or Local GAAP) are, we have considered, in addition to the research activities done in Europe, papers published outside Europe such as the FASB Discussion Paper issued in 2012. That paper had as objective the development of a decision-making framework to identify differential information needs of public and private companies and to identify opportunities to reduce the complexity and cost of preparing financial statements. In doing so, the Discussion Paper stated that the most common users of private company financial statements are lenders, other creditors and equity investors. This Discussion Paper pointed out that, in many cases, private companies prepare financial statements only to satisfy the terms of their lending agreements. In our study, we have considered the users’ needs of such private companies as we believe that the information needs of such companies are close to the information needs of the users of separate financial statements.
- A4.5 In addition, we have also considered the Discussion Paper *Relevance of Parent Entity Financial Reports* prepared by academics for the Australian Accounting Standards Board, which addressed the extent to which parent entity financial information is needed by users of general purpose financial reports. The Discussion Paper highlighted that many users of financial reports, predominantly those working in roles involving credit risk assessment, used information from the parent entity financial reports.

Equity Investors

- A4.6 Equity investors are those who have to take decisions about buying, selling or holding equity instruments of a company. Such decisions often depend on the level of risk and return that they expect from an investment in those instruments.
- A4.7 Equity investors have been identified as users of financial statements of an investor or parent regardless of whether they are prepared under IFRS or Local GAAP.
- A4.8 During the research phase, it appeared that equity investors were usually focused on consolidated financial statements when making investment decisions, and rarely used the financial statements of an investor or parent (regardless of whether they are prepared under IFRS or Local GAAP). This can be explained by the fact that the financial statements of a parent or an investor provide information about a single entity, and it would consequently be too burdensome to analyse each individual entity of a group. Whenever they are considered, those financial statements are used to supplement the information available in consolidated financial statements.
- A4.9 When they are related to an investment decision, those financial statements are used to assess expected future cash flows, cash dividends available to equity investors and the financial performance of an entity.
- A4.10 Equity investors look for information about a company's ability to generate cash to distribute dividends to its shareholders. In addition, those users look for information about the nature and extent of any significant restrictions of the entity's ability to transfer funds to its shareholders in the form of cash dividends. Such restrictions might be related to legal requirements, bank covenants, a dividends policy, borrowing arrangements, regulatory requirements or contractual arrangements. Information about significant restrictions is also important to help users determine the maximum amount that can be distributed as dividend.
- A4.11 Although companies usually disclose much information about dividends, our research showed that the information was often presented outside the financial statements (e.g. in the management report) because the computation of the dividends is often not within the scope of IFRS or Local GAAP, and depends to a large extent on Local legal requirements.
- A4.12 Equity investors occasionally need detailed information about a company's business activities and structure, such as information related to local markets and business segments, or an entity's performance when the investor or parent is an operating entity (e.g. recurring earnings analysis). This is particularly true when the information is very detailed in the financial statements of the single entity, and completes the information provided in the consolidated financial statements.

A4.13 Finally, our research also showed that the financial statements of an entity within a group were important if they had a legal role. This can be explained by the fact that the amount of dividends allowed to be distributed to shareholders is determined on the basis of the approved and audited financial statements that comply with local regulations.

Debt providers and other creditors

A4.14 Debt providers (e.g. banks) and other creditors (e.g. trade creditors) are those who have to take decisions about buying, selling or holding debt instruments of a company, providing or settling loans, and granting other forms of credit to a company. Those decisions often depend on the principal and interest repayments or other returns.

A4.15 Debt providers and other creditors have been identified as primary users of the financial statements of an investor or parent regardless of whether they are prepared under IFRS or Local GAAP, particularly when such financial statements have a legal role. Those financial statements are used to assess a company's financial position and performance, but also expected future cash flows. They are often used independently of or together with consolidated financial statements to access information about the entities within a group (e.g. parent or subsidiaries).

A4.16 Debt providers and other creditors need information about the economic resources of and the claims against a legal entity to assess its creditworthiness. Such an assessment is often based on liquidity, solvency, gearing and other financial ratios built on the accounting information of an entity. This is particularly true for private lending (such as bank loans) where financial covenants, based on audited financial statements, are an important feature of the loan contracts. The users also highlighted the need for information about the commitments and warranties that might affect liquidity, solvency and future cash flows. In addition to cash flows information, debt providers are also interested in information about the existence and value of the net assets available to repay the debt. Finally, they indicated that it was important to understand how management was using the entity's resources because, when the financial statements had a legal role, they could be of use in the case of a claim against a specific entity that was providing the guarantees.

A4.17 Debt providers and other creditors also often need information about a company's ability to generate cash to repay its loans. That assessment is often based on profitability ratios such as profit margin and cash flow turnover ratios. In addition, capital providers and other creditors look for information about the nature and extent of any significant restrictions of the entity's ability to repay debt. Such restrictions might be related to other borrowing arrangements, regulatory requirements or contractual arrangements.

A4.18 The users also expressed concerns about the adopted accounting policies and their compliance with the local legislation. The legal aspect was highlighted as it was the legal entity that had the capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, and was ultimately held responsible for its actions.

A4.19 Among the other creditors, the trade creditors also need information about the financial position and operational performance of an entity in order, for example, to make credit and pricing decisions.

Legal, regulatory and tax authorities

A4.20 Legal and regulatory authorities include entities such as financial regulatory authorities, market regulatory authorities (e.g. telecommunications) and courts. Legal and regulatory authorities have been identified as primary users of financial statements of an investor or parent, whether they are prepared under IFRS or Local GAAP. They use financial statements to assess a company's financial position and compliance with local regulatory requirements. This includes statutory filing according to commercial and bankruptcy laws, and capitalisation requirements (e.g. insurance and banking industry).

A4.21 Tax authorities are the official authorities that are empowered to collect taxes such as income taxes and levies. Tax authorities have been identified as primary users of the financial statements of an investor or parent, whether they are prepared under IFRS or Local GAAP. Those financial statements are used to assess a company's financial performance. Although the tax authorities can directly request the information they need to assess the collectability of an entity's obligations, they often turn to the financial statements as the starting point for determining taxable income.

Interested parties that have or intend to have transactions with an entity

A4.22 This group includes the parties that trade with an entity, or want to trade with it. This group encompasses customers, bidders, employees, etc.

A4.23 The financial statements of an investor or parent, whether they are prepared under IFRS or Local GAAP are often used to make decisions about mergers and acquisitions, decide whether to do business with an entity, and assess its ability to provide and pay benefits to its employees.

Practical financial reporting areas

A4.24 Our research revealed a wish for additional guidance for the following major financial reporting areas:

- a) Measurement of investments in separate financial statements;
- b) Common control transactions, including the accounting treatment of business combinations under common control in separate financial statements;
- c) Disclosures under separate financial statements, including disclosures on restrictions on the ability of an entity to distribute its equity (capital maintenance); and
- d) Clarification of the current terminology under IFRS.



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