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MFRS Hot Topics

Cost of an investment in a subsidiary in separate financial statements

JUNE 2014

Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue provides guidance on cost of an investment in a subsidiary in separate financial statements.

MFRS 127 Separate Financial Statements permits a parent to measure investments in subsidiaries in its separate financial statements (SFS) either at cost or at fair value under MFRS 139 (MFRS 127.10). This Hot Topic only considers the cost model, which is more commonly applied.

This Hot Topic provides various guidance when measuring investments in subsidiaries at cost in SFS in accordance with MFRS 127.

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Guidance

The MFRS Glossary of Terms defines cost as: ‘the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other MFRS, eg MFRS 2 Share-based payments. Neither this definition nor MFRS 127 provides specific guidance on the issues addressed in this Hot Topic.

Through the amendments made in the adoption of MFRS, the ‘cost method’ (under which distributions paid out of pre-acquisition profits were treated as a reduction of the cost of the investment) is no longer applicable. Accordingly, cost in MFRS 127 is presently defined per the definition quoted above.

Contingent consideration arrangements

In purchasing an investment in a subsidiary, a parent entity might agree to transfer additional assets or equity interests to the vendor if specified future events occur or conditions are met (or the parent might have the right to the return of amounts paid under specified conditions). These arrangements are referred to as contingent consideration in MFRS 3 Business Combination.

Contingent consideration in a business combination

In summary, MFRS 3's requirements on contingent consideration are as follows:

- contingent consideration is included in the consideration transferred at fair value at the acquisition date (unless it represents something other than consideration transferred for the acquiree) (MFRS 3.37 and 39);
- the obligation to pay contingent consideration is recorded as a financial liability or equity item in accordance with definitions in MFRS 132 or other applicable MFRSs (MFRS 3.40); and
- after the acquisition date a recognised financial asset or liability for contingent consideration is measured at fair value with gains or losses recognised in profit or loss. Contingent consideration classified as equity is not remeasured (MFRS 3.58(a)).

An acquirer's contingent consideration contract is no longer scoped out of MFRS 132 Financial Instruments: t foPresentation and MFRS 139 Financial Instruments: Recognition and Measurement. Such a contract is therefore accounted for in accordance with those Standards where

MFRS 3.58(b)(ii) also refers to a contingent consideration asset or liability within the scope of MFRS 137 Provisions, Contingent Liabilities and Contingent Assets or another MFRS. In practice we believe that most arrangements will be within the scope of MFRS 132 or MFRS 139, and that MFRS 137 will apply only rarely.

MFRS 3 addresses the treatment of contingent consideration in the context of business combination accounting. There is no explicit guidance on its treatment in measuring cost in SFS. In our view:

- at the date of obtaining control, the parent should include the fair value of a contingent consideration obligation (or right) as part of the cost of its investment in a subsidiary, consistent with the MFRS 3 treatment in business combination accounting. We believe that this is consistent with the definition of cost and also reflects the fact that the contingent consideration contract will need to be included as an asset, liability or equity item in accordance with MFRS 132 or MFRS 139 if applicable (in both the consolidated financial statements and in the SFS);
- when the fair value of a contingent consideration contract within the scope of MFRS 139 changes, our preferred view is that gains and losses are recorded in profit or loss in the SFS consistent with the approach required by MFRS 3.

Previously-held interests at the date of obtaining control

Prior to obtaining control over an entity, a parent/investor might have held an existing (non-controlling) investment in that entity. Such an investment might have been an associate, joint venture (noting that such investments are measured at cost or in accordance with MFRS 139 in SFS), or a financial asset within the scope of MFRS 139. A financial asset within the scope of MFRS 139 might be classified (i) as held for trading and measured at fair value through profit or loss; or (ii) as available for sale and measured at fair value with gains/losses (except impairment losses) recorded in other comprehensive income (OCI); or (iii) at cost less impairment if fair value is not reliably measurable.

MFRS 3 views previously held interests in investment assets as part of what is exchanged for a controlling interest in all of the acquiree's underlying assets and liabilities (MFRS 3.BC384). As a result, MFRS 3 requires that:

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

There is no explicit guidance on how to treat previously-held interests in measuring cost in SFS. In our view, MFRS 3's characterisation of a previously-held interest as part of what is exchanged for control of the acquiree can be extended to the measurement of cost of an investment for MFRS 127 purposes. However, a more traditional view of cost as the total of the costs at each stage of the purchase is also acceptable (noting that cost in MFRS 127 and consideration transferred in MFRS 3 are different concepts).

Accordingly, we believe that the parent has an accounting policy choice in its SFS to:

- apply the MFRS 3 approach described above, or
- treat the total cost of the investment as the cost incurred to acquire the previous investment plus the cost of the interest that confers control. Under this approach:
  - if the previous investment has been measured at cost (less impairment), the cost of the controlling interest is simply added to the carrying value of the previous (non-controlling) interest. We believe that any past impairment loss recognised should be viewed as establishing a new cost basis and should not therefore be reversed;
  - if the previous investment has been measured at fair value (as a held for trading or available for sale financial asset), gains and losses recognised prior to obtaining control would need to be reversed in order to restate the investment to cost. We believe this restatement should be effected by adjusting the appropriate component of equity ie the component that includes the previous gain or loss (typically retained earnings in the case of a held for trading investment, or an AFS reserve in the case of an available for sale financial asset). We do not believe the restatement to cost results in gains or losses in profit or loss or OCI under this approach because it is not a gain or loss as defined in the Conceptual Framework.

Example - Previously-held available for sale investment in the SFS

Entity P is a parent entity and prepares both consolidated and separate financial statements. At 31 March X0 it holds a 10% equity interest in Entity S, which is classified as an available for sale financial asset. The original cost of the investment was CU50. At 31 March X0 the fair value and carrying value is CU70. The cumulative gain of CU20 has been recognised in OCI and is included in a separate AFS reserve in Entity P's consolidated and separate financial statements.

At 01 April X0 Entity P acquires the other 90% of Entity S for cash consideration of CU630, with Entity S becoming a subsidiary at that date. Acquisition-related costs are not significant. Entity P's accounting policy for investments in its subsidiaries in the separate financial statements is to use cost. How is the previous investment treated in applying this policy?

Option 1 - apply MFRS 3 approach

The fair value of the previous investment (CU70) is included as part of the cost of the total interest in Entity S, which is therefore CU700 (CU70 + CU630). The cumulative gain previously recognised within OCI is reclassified into profit and loss. The required journal entry is as follows:

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

Option 2 - treat cost as the cost of each stage

The original cost of the previous investment (CU50) is included as part of the cost of the total interest in Entity S, which is therefore CU680 (CU50 + CU630). The cumulative gain of CU20 previously recognised within OCI and included in the carrying amount of the AFS asset is reversed against the AFS reserve within equity. There is no effect on profit & loss or OCI for the period. The required journal entry is as follows:

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

If the previous investment has been classified as held for trading the Option 1 approach would simply involve adding the cost of the new 90% interest to the fair value of the previous 10% interest. There would be no effect on profit or loss at the date of acquiring the 90% interest. Under the Option 2 approach, the accounting would be similar to the above journal entry but the previous fair value movement (which would have been reported in profit or loss) would be eliminated against retained earnings.

In obtaining control over a subsidiary, a parent entity might incur various expenses in addition to amounts payable to the vendor, such as legal, accounting and consulting fees. MFRS 3 requires that acquisition-related costs are accounted for as an expense when incurred or when services are rendered (other than costs to issue debt or equity securities, which are accounted for in accordance with MFRS 132 or MFRS 139 as applicable) (MFRS 3.53).

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