ISSUE PAPER ON
DEEMED COST OF A SUBSIDIARY
IN FIRST TIME APPLICATION

The issue:

The IFRS 1, paragraphs 16-18, specifically permit, under certain conditions, a IFRS first-time adopter to elect to measure, at fair value or previous GAAP revaluation as deemed cost, an item of property, plant and equipment, investment property or intangible assets. This Standard, however, does not specifically address a similar exemption for recalculating the initial cost of an investment at time of transition to IFRS.

As a consequence, in accordance with the requirements of IAS 27, in the parent company separate financial statements the investments in subsidiaries, associated entities and joint ventures, which were accounted for with the equity method under previous GAAP, should be measured, either at cost, or at fair value in accordance with IAS 39 (unless these investments are defined as held for sale). It is to be noted that paragraph 4 of IAS 27 provides a definition of the "cost method", but then it does not address any specific exemption or alternative for the case where there is little (or none) mean to retroactively determine the value of the acquisition consideration.

Current practice:

The requirements of IFRS 1 and IAS 27 are particularly burdensome in those jurisdiction where the parent entity separate financial statements are prescribed to be IFRS compliant and for which the measurement at fair value of their investments in subsidiaries results unreasonably costly or very difficult to be applied. The reconstruction of the IAS 27 compliant original consideration paid may result severely troublesome for those entities which have historically measured their investments with the "equity method" as required by previous GAAP.

Several factors - or any combination of them - contribute to such a difficulty. Among these, we may mention: the acquisition of the entity may have occurred in a far past year; allocation of dividends paid between pre-acquisition and post-acquisition profits and their treatment under local standards has been treated differently than IFRSs; the acquisition may have been made in steps at various times over the years; the entity may have acquired the control of the subsidiary subsequent to an initial investment; the entity could have directly formed its subsidiary, as well as it could have been acquired in the market through a business combination transaction.

Furthermore, the resulting retroactively reconstructed cost is likely to result in an unrealistic amount considerably lower than the fair value of the investment, particularly when the acquisition took place many years before. As a consequence, the fairness of the reconstructed cost as well as the actual utility of the information to the reader can be arguable.

Finally, it appears unlikely that the cost of such remeasurement is fairly balanced by the benefit of the information so obtained.

Reasons for the IFRIC to address the issue:

We are aware that the issue is included un the Board agenda and that several options are being under study, including a possible revision of both IFRS 1 and IAS 27. However, because of the time necessary for resolving the controversial and complex implications of the issue when compared to its relevance, a solution is not likely to be ready in the due time, so that entities might be tempted to adopt an approach which may subsequently demonstrate not to be IFRS compliant. Any subjective interpretation made by the preparers of financial reports during this time may have significant consequences.

Accordingly, it would be necessary a transitional provision of a reasonable method for calculating the deemed cost of the investment in the first time application of IFRSs.

Absent a similar exemption, the current standards may cause additional costs to the preparers for restating their prior period non-compliant consolidated accounts, as well as possible fluctuations in the stock markets and different opinions by the financial analysts. We believe that in the wait for a revised version of relevant requirements an IFRIC interpretation as to the possibility of an extension of current exemptions is appropriate.

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