



IAS 27: PROBLEMS FOR UK COMPANIES ICAEW BRIEFING PAPER

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INTRODUCTION

1. The Financial Reporting Committee of the Institute of Chartered Accountants in England and Wales has identified an issue of some significance for UK companies adopting International Financial Reporting Standards. A summary of the issues is set out below. The issue has been drawn to the attention of the International Accounting Standards Board, the UK Accounting Standards Board and the Department for Trade and Industry.

THE ISSUE: DISTRIBUTIONS FROM PRE-ACQUISITION PROFITS

2. The issue arises where parent companies wish to move their individual accounts from national GAAP to IFRS. IAS 27 requires investors to recognise income from a subsidiary 'only to the extent that the investor receives distributions from accumulated profits of the investee arising after the date of acquisition'. Any distributions received out of pre-acquisition profits are treated as a recovery of part of the cost of the investment.
3. The requirements of IAS 27 mean that on adoption of IFRS, a parent company must examine all past distributions made by each of its subsidiaries to determine whether they were paid from pre-acquisition profits. Some parent companies have a substantial number of subsidiaries and will need to locate and examine data - which in some cases may no longer be available or obscured by intra-group reorganisations - from the date of the initial acquisition of the investment. In many cases this is likely to prove a highly onerous task. In our view there is strong case on the grounds of cost and impracticality for providing relief from this requirement, analogous to the rationale for the exemption in IFRS 1 regarding the determination of cumulative exchange differences.
4. We would welcome an early amendment to IFRS 1 to ease a significant cost burden on companies. This might mean, for example, permitting first time adopters to treat the carrying value determined under national GAAP as deemed cost, applying IAS 27 to future distributions.
5. There are also concerns in Europe - and in the UK in particular - over the distributable profits implications of the requirement to set all pre-acquisition dividend income against the cost of the investment, regardless of whether or not the recoverable amount of that investment continues to be at least equal to its carrying value. Whilst this should not affect the standard setting process, we note that this represents a significant disincentive to

European companies contemplating a complete switch to IFRS. Although there are plans in Europe to commence a fundamental project to reconsider the basis on which profits available for distribution are calculated, possibly leading to the introduction of a solvency test, any change is unlikely to be implemented for a number of years. Many companies will therefore continue to run parallel accounting systems - national GAAP and IFRS - at some significant cost.

6. In the longer-term, we would support deletion of the requirement in IAS 27 for distributions received out of pre-acquisition profits always to be treated as a recovery of part of the cost of the investment. The objective of this requirement is presumably to prevent the treatment of a return of capital as income. However, its logic seems uncertain. The nature of an equity investment - a simple financial asset - is that its value changes over time and it generates cash flows from time to time. If a subsidiary that cost £100 and has increased in value by £50 (not recognised in the investor) pays a dividend of £30, its value falls necessarily to £120. Should one say that the £30 came out of the original £100, or out of the subsequent £50? Since the value is entirely fungible, it would seem arbitrary to treat it as a return of part of the original investment of £100 when the current value of the investment is £120. As the investor continues to hold an investment worth at least £100, plus some cash, it would seem logical to treat the £30 of cash received as income. Alternatively, it might be argued that even profits accruing after the date of acquisition were paid for as part of the purchase price and are in the nature of a return of capital. Not surprisingly, a similar provision was dropped from UK law over twenty years ago.
7. There are a number of uncertainties that arise when companies seek to apply the IAS 27 requirement. For example, when a group is acquired, does the reference to the 'investee' refer to the legal entity acquired or to the acquired group? Does the question of whether the dividend is paid out of pre-acquisition profits have to be determined on the basis of IFRS even for a subsidiary that uses a different GAAP as a basis for justifying the payment of the dividend? Where a subsidiary reports under IFRS, should the question of what is pre-acquisition be affected by accounting policy choices? For example, if a property is revalued under IAS 16 prior to acquisition and then sold at its revalued amount post-acquisition, is this a pre-acquisition profit even though it would have been reported post-acquisition using an historical cost accounting policy? There is also a great deal of uncertainty about how to apply the requirement when there have been group reorganisations.
8. In the shorter term, IAS 27 could be amended to permit dividends from subsidiaries to be treated as investment income, subject to an impairment test of the value of the subsidiary in the parent's accounts. If an impairment test is required each time a distribution is made, this would instead identify returns of investment (that should be taken against the cost of investment) on a far more logical substance-basis. The fact that the IAS 27 definition applies only when a company is using the cost method for its investments in subsidiaries reinforces our view that the most appropriate approach when deciding whether income can be recognised is to reassess the carrying value of the investment on receiving any dividend, from whatever profits it might have been paid. A similar change would have to be considered to IAS 18, paragraph 32.

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