Financial Reporting Alert

ASPE

JULY 2017

Subsidiaries, Investments and Interests in Joint Arrangements

In December 2016, the Accounting Standards Board (AcSB) issued amendments to the following Sections in Part II (Accounting Standards for Private Enterprises) of the *CPA Canada Handbook – Accounting*:

- Section 1591, *Subsidiaries*
- Section 3051, *Investments*
- Section 3056, *Interests in Joint Arrangements*

This *CPA Canada Financial Reporting Alert (Alert)* highlights the key changes resulting from these amendments and considers some possible assurance implications.

What Are the Main Objectives of the Amendments?

The main objectives of the amendments are:

- to provide guidance on how to apply the cost method when recognizing subsidiaries and other investments using the cost method (**Note:** this includes impairment and subsequent measurement)
- to improve disclosure requirements when the cost method is used
- to clarify that when an enterprise prepares non-consolidated financial statements, it is not required to identify and disclose information about subsidiaries controlled through contractual arrangements

- to clarify that the transitional provisions in Sections 1591 and 3056 can only be used during transition to those standards or during the initial adoption of ASPE
- to provide additional indicators of impairment relating to the acquisition of an additional interest, sale of a portion of an interest or dilution of an investor's interest in an investee.

The Cost Method of Accounting for Investments

Cost is an acceptable method of accounting for subsidiaries, investments subject to significant influence, and some joint arrangements (i.e., jointly controlled enterprises when the investor uses the cost method). The amendments discussed in this *Alert* are related to the application of the cost method. Section 3051 includes a definition of the cost method:

> **The cost method is a basis of accounting for investments whereby the investment is initially recorded at cost; earnings from such investments are recognized only to the extent received or receivable (see paragraph 4(b) of Section 3051)**

Who Applies these Amendments?

The principal users of these amendments will be **private enterprises** that apply Part II of the *Handbook* and:

- are applying the transitional guidance on the initial adoption of Section 1591 for subsidiaries and Section 3056 for joint arrangements (2017 amendments)
- account for interests in subsidiaries or investments subject to significant influence using the **cost** method (2018 amendments).

Not-for-profit organizations are not affected by these amendments. Controlled organizations are consolidated (unless they hold a large number of immaterial organizations) and account for investments subject to significant influence using the equity method.

> **Reminder:** Not-for-profits applying Part III must apply Section 4450, Repo*rting Controlled and Related Entities by Not-for-profit Organizations*, when accounting for interests discussed in this Alert.

When Are the Amendments Effective?

The following chart provides a summary of the amendments classified by section and effective date:

	Section 1591, *Subsidiaries*	Section 3051, *Investments*	Section 3056, *Interests in Joint Arrangements*
2017 (Effective for annual periods beginning on or after January 1, 2017)	• amendments to transitional guidance • preparation of non-consolidated financial statements — subsidiaries controlled through contractual arrangements		• amendments to transitional guidance
2018 (Effective for annual periods beginning on or after January 1, 2018)	• application of cost method, and some additional clarifying amendments	• application of cost method • indicators of impairment	

Reminder: Section 1591 and Section 3056 and the amendments to Section 3051, to which some of these amendments relate, are effective for annual financial statements relating to fiscal years beginning on or after January 1, 2016, though earlier application was permitted (see CPA Canada's "ASPE Briefing: Accounting for Investments (sections 1591, 3051, and 3056)" for additional guidance on these standards).

What Are the Key Amendments?

This *Alert* addresses the key amendments by the effective dates of annual financial statements for fiscal years beginning on or after:

- A: January 1, 2017 (Section 1591 and Section 3056)
- B: January 1, 2018 (Section 1591 and Section 3051)

A: Effective for annual financial statements relating to fiscal years beginning on or after January 1, 2017

Section 1591, *Subsidiaries*	Section 3056, *Interests in Joint Arrangements*
Amendments to clarify that: 1. The transitional provisions in paragraphs 1591.42-47 can only be applied to annual financial statements relating to the first fiscal year in which Section 1591 is applied and cannot be applied when an enterprise changes its accounting policy choice to consolidate its subsidiaries (i.e., the relief provided in the transitional guidance is only available to enterprises transitioning to Section 1591 for the first time). 2. An enterprise preparing **non-consolidated** financial statements is not required to assess whether contractual arrangements give rise to control (see paragraph 23A of Section 1591). This is a very important clarification since many private enterprises only prepare non-consolidated financial statements. However, it must be noted that the policy choice under paragraph 1591.24(b) to not consolidate subsidiaries must be made for all interests in subsidiaries. Therefore, if consolidated financial statements are prepared, then the enterprise must determine whether any subsidiaries arise from contractual arrangements either on their own or in combination with equity or potential equity interests.	Amendment to clarify that: The transitional provisions in paragraphs 3056.44-49 can only be applied to annual financial statements relating to the first fiscal year in which Section 3056 is applied and cannot be applied when the enterprise changes its accounting policy for accounting for joint arrangements (i.e., the relief provided in the transitional guidance is only available to enterprises transitioning to Section 3056 for the first time (see paragraph 43B of 3056)).

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When an investor is preparing non-consolidated financial statements is it REQUIRED that the investor look for subsidiaries controlled by contracts?

No, once the policy choice not to consolidate all subsidiaries is made, there is no requirement under Section 1591 to identify the possible subsidiaries created through contract.

Reminder: When non-consolidated financial statements are prepared, the basis used to account for an enterprise's subsidiaries must be disclosed (see paragraph 36 of Section 1591).

B: Effective for annual financial statements relating to fiscal years beginning on or after January 1, 2018

Section 1591 provides an accounting-policy option for private enterprises to consolidate their subsidiaries or account for their subsidiaries using either the equity method or the cost method. The amendments to Sections 1591 and 3051 primarily address the use of the cost method, including the initial measurement of the investment. The amendments are based on the principle that an interest in a subsidiary should initially be measured on a similar basis, regardless of the subsequent accounting policy choice.

Amendments to Section 1591, *Subsidiaries*

Application: The amendments to Section 1591 issued in December 2016 are generally applicable to annual financial statements relating to fiscal years beginning on or after January 1, 2018. Earlier application is permitted.

Initial measurement

- Cost is measured at the acquisition-date fair value of the consideration transferred, including measurement of any contingent consideration:
  - When a subsidiary is acquired by an exchange of only equity interests, the acquisition-date fair value of the subsidiary's equity interests may be more reliably measurable than the acquisition-date fair value of the enterprise's equity interests. If so, the enterprise must determine the fair value of the consideration transferred by using the acquisition-date fair value of the subsidiary's equity interests instead of the acquisition-date fair value of the enterprise's equity interests transferred.
  - When an investment in a subsidiary is acquired in two or more transactions at the same or different dates, the cost of the investment is the sum of the costs of the separate transactions.
- When an enterprise and the subsidiary have a pre-existing relationship or other arrangement that existed before negotiations for the acquisition of the subsidiary began, or the enterprise enters into an arrangement during the negotiations that is separate from the acquisition of the subsidiary, including the remuneration of employees or former owners of the acquiree for future services or reimbursement of the acquiree or its former owners for paying the acquirer's acquisition-related costs, then the requirements in Section 1582, *Business Combinations*, are applied. Acquisition costs incurred are recognized as an expense, except for costs to issue debt and equity securities (see Section 3856, *Financial Instruments* and Section 3610, *Capital Transactions*).
- A bargain-purchase gain on the purchase of a subsidiary is not recognized.
- A previously held investment is not remeasured in a step acquisition.
- If the initial accounting for a subsidiary is incomplete by the end of the reporting period in which the acquisition occurs (e.g., because of a working capital adjustment clause), the carrying amount must include a provisional amount. The amendments address the accounting for any provisional

amounts in subsequent periods as well as provide guidance on any acquisitions that were incomplete prior to the applications of these amendments (see paragraphs 26B(d) and 39C of Section 1591).

Subsequent periods

- Recognize earnings from subsidiaries only to the extent received or receivable.
- At the end of each reporting period, the requirements on impairment in Section 3051 must be applied (see additional guidance on indicators of impairment in the **Reminder** in the following section).
- When the contingency is resolved, contingent consideration must be remeasured on the same basis as required by Section 1582.
- The provisional carrying amount, if any, of the interest in the subsidiary is to be adjusted in the period in which the provisional amounts are finalized; this measurement period must not exceed one year from the acquisition date.
- Guidance on accounting for the interest when an ownership interest in a subsidiary decreases or increases in subsequent periods is addressed (i.e., sale or purchase of a portion of the interest or dilution).

Disclosure

- Disclosures related to non-consolidated financial statements using the cost or equity method are clarified.

Reminder: If interests in subsidiaries exist, even if there are no measurement changes in the accounting for these interests and no new acquisitions in the current period, it is important to check that the notes to the financial statements meet the new requirements once these amendments are applied.

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Is the accounting for common-control transactions addressed in these amendments?

No, the amendments actually clarify the scope of common-control transactions.

For further discussion of common-control transactions, specifically amalgamations, see CPA Canada's **ASPE Briefing, Amalgamations of Wholly-owned Enterprises (January 2017)**

Amendments to Section 3051, *Investments*

Application: The amendments to Section 3051 issued in December 2016 are applied to annual financial statements relating to fiscal years beginning on or after January 1, 2018. The amendments may be applied prospectively as defined in 1506.05(g). Earlier application is permitted.

Initial measurement

- Cost is measured at the acquisition-date fair value of the consideration transferred, including measurement of any contingent consideration:
  - When an investment subject to significant influence is acquired by an exchange of only equity interests, the acquisition-date fair value of the investee's equity interests may be more reliably measurable than the acquisition-date fair value of the enterprise's equity interests. If so, the enterprise must determine the fair value of the consideration transferred by using the acquisition-date fair value of the investee's equity interests instead of the acquisition-date fair value of the enterprise's equity interests transferred.
  - When an interest subject to significant influence is acquired in two or more transactions at the same or different dates, the cost of the investment is the sum of the costs of the separate transactions.
- Acquisition costs incurred are recognized as an expense, except for costs to issue debt and equity securities (see Section 3856, *Financial Instruments* and Section 3610, *Capital Transactions*).
- New indicators of impairment have been added for consideration when an additional interest in an investee is acquired or when the interest in the investee is diluted.

Subsequent periods

- One of the most significant amendments is the additional guidance on indicators of impairment.

> **Reminder: For each reporting period, an investor must assess whether there are any indications an investment may be impaired.**

  - When there is an indication of impairment, an investor must determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the investment.
  - The following indicators of impairment have been added as part of the amendments:
    - » an acquisition of an additional interest or the sale of a portion of an interest in an investee for consideration paid or received that is less than the proportionate share of the carrying amount of the interest in an investee immediately before the acquisition or sale

» a dilution of an investor's interest in an investee that indicates the expected amount of future cash flows from holding or selling the investment is less than the carrying amount of the investment immediately before the dilution.

Disclosure

- Disclosures related to non-consolidated financial statements using the cost method have been clarified.

Reminder: If strategic investments exist (i.e., investments subject to significant influence and interests in subsidiaries), even if there are no measurement changes in the accounting for the investments and no new acquisitions in the current period, it is important to check that the notes to the financial statements meet the new requirements once these amendments are applied.

Are There Any Consequential Amendments?

- Section 1500, *First-time Adoption*—to allow an investor adopting Part II for the first time to apply the transition provisions from Sections from 1591 and 3051
- Section 1506, *Accounting Changes*—to clarify the guidance on a change in accounting policy related to accounting for subsidiaries and investments subject to significant influence
- Section 1582, *Business Combinations*—to clarify that certain disclosures are required only when consolidated financial statements are prepared (i.e., Section 1582 requires an acquirer that prepares consolidated financial statements to disclose for each material business combination the amount of any gain recognized in a bargain purchase, the acquisition-date fair value of a pre-existing equity interest in the acquiree, and the amount of any gain or loss recognized as a result of remeasuring the pre-existing equity interest to fair value)
- minor editorial corrections to Sections 1582, 1591, 3051 and 3240.

What Are the Possible Assurance Implications?

The amendments discussed in this *Alert* related to the accounting for certain investments may require practitioner and management to discuss:

- the identification of any investments held or acquired that are affected by the amendments related to the use of the cost method and to determine whether new information is needed to determine the cost of future investments or the potential impairment of existing investments
- how management intends to apply the amendments and make sure the various effective dates are considered for each amendment.

In addition, the following considerations may be relevant in assurance engagements:

- provision by management of sufficient financial information for any investments affected by these amendments to appropriately account for the investments, including any assessment for impairment
- determination of whether the planned procedures are appropriate (e.g., consideration of management's analysis of any investments affected by the amendments when identifying a risk of material misstatement (audit) or an area where it is likely a material misstatement will arise (review))
- updating the documentation of the understanding of the entity so that it appropriately reflects the current state (e.g., the entity's identification of its investments, and the selection of its policy choices)
- consideration of the reporting requirements related to retrospective application, if any.

What Resources Are Available to Help Me?

CPA Canada

- ASPE Briefing: Accounting for investments (sections 1591, 3051, and 3056)
- Guide to ASPE

Accounting Standards Board

- FYI Article — Accounting for Investments: Are You Ready For the Changes?

2017 Amendments

- Basis for Conclusions — Clarifications to Sections 1591 and 3056
- FYI Article — Subsidiaries and Interests in Joint Arrangements: Take Advantage of the Transitional Provisions in 2016

2018 Amendments

- Basis for Conclusions — Subsidiaries and Investments — Sections 1591 and 3051
- FYI Article — Clarifying the Cost Method: Subsidiaries and Investments
- Webinar — AcSB Exposure Draft: Subsidiaries and Investments — Accounting Standards for Private Enterprises

Comments on this *CPA Canada Financial Reporting Alert*, and suggestions for future Financial Reporting Alerts should be sent to:

Taryn Abate, CPA, CA, CPA (IL)
Research, Guidance and Support
Chartered Professional Accountants of Canada
277 Wellington Street West
Toronto ON M5V 3H2
email: tabate@cpacanada.ca