ICAEW REPRESENTATION 170/14

ICAEW REPRESENTATION

SEPARATE FINANCIAL STATEMENTS

ICAEW welcomes the opportunity to comment on the discussion paper (DP), *Separate Financial Statements*, published by the European Financial Reporting Advisory Group (EFRAG), the Instituto de Contabilidad y Auditoría de Cuentas (ICAC), the Organismo Italiano di Contabilità (OIC) and the Raad voor de Jaarverslaggeving (RJ) on 1 September 2014, a copy of which is available from this link.

This response of 31 December 2014 has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

For more information, please contact frfac@icaew.com

icaew.com

MAJOR POINTS

Support for the initiative

1. We welcome the initiative of EFRAG and its associated bodies in issuing a discussion paper (DP) on the subject of separate financial statements as a means of flushing out debate on the subject within the EU. We are not convinced, though, that there are such significant problems with separate financial statements that prescription of practice is required and, to the extent that such problems exist, they are probably European rather than global. The DP's evidence is restricted to Europe and, as a global standard setter, it would be inappropriate for the IASB to tackle an issue unless it can be shown to be a global issue rather than a purely local or regional one.

2. This raises a general question about EFRAG's approach to topics on which it is being proactive. While it is understandable that EFRAG should raise issues that may be of particular concern in Europe, if the intention is to influence the IASB, they need to be approached in a way that shows that they are not only European, but are genuinely global. Where an issue arises purely because of local requirements, which we suspect to be the case with separate financial statements, then they are probably best dealt with by local guidance. This allows for local flexibility, particularly where differences in practice are driven by different local legal and regulatory issues, leaving the IASB to focus on issues that are more appropriate for an international standard setter.

3. As we have stated above, however, we are not convinced at present that in the specific case of separate financial statements there are significant problems even in Europe, and partly for this reason we would not support specific European guidance on the matter. Also, even within Europe, relevant requirements vary from country to country, so it is in any case doubtful how useful guidance at the European level would be, supposing it were needed in the first place. Perhaps it would be more useful for the EU to consult the users of financial reporting on how far they find separate financial statements helpful and, in the light of this, to review the requirements that lead to their production. We note that the US, for example, has no requirement for separate financial statements, and appears to manage perfectly well without them.

4. The DP identifies, at Appendix 1, which EU countries require or permit the use of IFRS for companies' entity accounts. This is a useful survey, but it would be helpful to extend it to review, in both those countries where national GAAP still applies and where IFRS is used, national accounting practices in separate financial statements for the various issues discussed in the DP, such as accounting for transaction costs, accounting for contingent consideration, and common control transactions. This would demonstrate the variety of practice and might indicate the extent to which further guidance is required. As indicated above, while it is natural that EFRAG should focus on the EU, it would be helpful for such a survey to look at non-EU countries as well, if separate financial statements are indeed a global problem.

How the IASB should respond

5. The IASB's focus is, rightly in our view, on consolidated financial statements, and so the existence of IAS 27, *Separate Financial Statements*, could be seen as an anomaly. None the less, it is probably helpful to those companies that either choose to prepare separate financial statements or are required to do so. Although we have no statistics on the question, we suspect that most companies that prepare separate financial statements are doing so because they are required to do so, as in the UK they are not generally seen as particularly useful for those outside the company and would be unlikely to be prepared voluntarily except for management purposes.

6. IAS 27 as it stands does not take a strongly prescriptive approach, and we believe this is appropriate. It may be useful, though, for the IASB to review all its requirements currently applicable to separate financial statements and to develop a general principle or principles that will govern its approach to setting requirements for them. We envisage that this would set out which aspects of separate financial statements the IASB regards as significant from its point of view and which it does not. We do not envisage that this would lead to more prescriptive requirements than exist already, but rather that it would provide a defence against potential criticisms that the IASB ought to be more prescriptive.

7. Such an approach might well lead to the IASB explicitly accepting that local guidance may be appropriate where problems arise because of local legislative or regulatory requirements. This would be contrary to the IASB's general stance, but we believe that on an issue such as this, which in our view largely arises from local requirements, it would be a sensible response. We believe the IASB would be likely to favour such an approach towards separate financial statements were it to decouple further the question of separate financial statements from that of individual financial statements, where the IASB has more of a locus in what are comparatively rare non-group situations (in the context of the IASB's focus on listed companies).

RESPONSES TO SPECIFIC QUESTIONS

Introduction

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.

8. We believe that Chapter 1 of the DP accurately sets out the framework of separate financial statements in Europe in general terms and correctly notes that they vary from country to country. Appendix 1 of the DP gives more detail for each country. However, as a matter of principle, when EFRAG wishes to influence the IASB on a subject, it may be beneficial to look at how far other non-European IFRS jurisdictions have similar problems, not least to identify natural allies and to interest them in the question.

The use of financial statements of a parent or an investor, regardless of whether they are prepared under IFRS or Local GAAP

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.

9. We believe that Chapter 2 of the DP overstates significantly the usefulness of separate financial statements, ie, company financial statements that look to a legal boundary when the company is part of a group that is, in contrast, defined on a more economic basis by IFRS. Paragraph 2.18 of the DP identifies six respects in which the financial statements of a parent company or investor are important to users.

a) 'Assess cash dividends to shareholders taking into account any restrictions that might apply'. Parent/investor company accounts are unlikely to provide this information, nor will the aggregate of subsidiary company accounts. While the management of the dividend-paying company needs to ensure that it complies with all applicable legal requirements, and in some jurisdictions it will need to refer to the company accounts in order to do this, in deciding on a dividend it will look at the resources available across the group. This is likely to involve dividend payments from subsidiaries to the parent company to enable the parent company in turn to pay a dividend to its shareholders. The potential for such payments from subsidiaries will not be evident from the parent company's accounts. Also, even where reserves exist in a company, this does not necessarily mean that they are distributable. Indeed, the amendments to IAS 27 published by the IASB shortly before the DP's publication (but not reflected in it), which allow the equity method in separate financial statements, are likely to make parent company reserves even less closely related to distributable profits. This might also be the effect of any moves towards increasing use of fair value in separate financial statements, which the DP contemplates for some items.

b) 'Make financing decisions (eg, creditworthiness)'. While we recognise that some lenders do indeed make use of separate financial statements, we do not believe that they make significant lending decisions based primarily on separate financial statements. It is usually more important for them to consider the position of the group as a whole, and to ensure where appropriate that cross-guarantees are in place across the group, particularly in the case of group facilities.

c) 'Make decisions about potential mergers and acquisitions'. We do not believe that anyone makes decisions about potential mergers and acquisitions based primarily on separate financial statements when a group acquisition is in contemplation. Again, the position of the group is more relevant. Even if one company in a group is being sold and acquired, the price will generally not be set by reference to the accounts without adjustment for the impact of related party (intra-group) transactions. But generally such sole company divestments are rare; it is more common for a sub-group to be sold as it represents a business segment. In any case, it is common for special purpose accounts to be prepared specifically for the transaction, particularly if preceded by an internal reorganisation at the selling group.

d) 'Assess compliance with the legal and regulatory requirements'. We do not see what legal and regulatory requirements would be relevant here, other than, in some jurisdictions, restrictions on the distribution of profits and assessment of tax, but other methods could be used to fulfil the statutory purpose. Even in the case of distributable profits, as noted above, it cannot be assumed that accumulated profits shown in separate financial statements are necessarily distributable.

e) 'Assess the financial position and operational performance of the parent or investor'. Separate financial statements are a poor basis on their own for assessing the financial position and operational performance of a parent company. Its financial position will often depend on its ability to transfer funds from subsidiaries and its operational performance considered separately from its subsidiaries (and as shown in the group accounts) is usually meaningless.

f) 'Assess the liquidity of an entity'. Again, a company's liquidity will often not be apparent from its separate financial statements, as it may well depend on arrangements for the transfer of funds within the group.

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.

10. For the reasons discussed in our response to Question 2.1, we do not think that separate financial statements are in fact significantly useful to most users, including, with the exception of some lenders, those identified at paragraphs 2.13 to 2.17 of the DP.

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?

11. Although, as indicated, we are sceptical about how useful separate financial statements are, holders of non-controlling interests in subsidiaries may wish to see the parent company's accounts to help them understand the relationships between the parent company and its majority-owned subsidiaries and, hence, their own position, as well as the separate financial statements of the subsidiary itself. However, their information rights and ability to force arms' length transactions between the subsidiary and its group will often be enforced through a shareholder agreement, which can be drafted as suited to the purpose of the relevant parties, or by using the provisions of company law intended to protect minority shareholders' rights. Specific IFRS requirements for the separate financial statements are therefore not necessary.

Accounting policies to be applied in separate and consolidated 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.

12. We do not believe that it is possible to establish general rules as to when the accounting policies to be applied in separate and consolidated financial statements should and should not differ. Each entity – the company and the group – should adopt the accounting policies appropriate to its transactions and business models.

Accounting for transaction costs and contingent consideration

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.

13. We believe that the accounting for acquisition-related costs should be consistent with the principles of accounting standards relating to the acquisition of other types of asset, ie, that acquisition-related costs should be part of the initial measurement of investments in subsidiaries, joint ventures and associates accounted for at cost.

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.

14. Measurement of contingent consideration at fair value in the parent company's accounts would, in our view, be inconsistent with the purpose of such accounts. It would also, if the fair value gains and losses were recognised in the income statement when the parent is using the cost basis for the investments themselves, have the counter-intuitive effect that better than expected performance by an acquired company, leading to higher contingent consideration, would result in a reported loss in the parent company's accounts without any offsetting gains that might be recognised in the consolidated accounts. The same issue would arise, even in the absence of fair value remeasurements, if differences between the expected amount of contingent consideration measured at the date of acquisition and the amount ultimately paid were recognised in the parent's income statement.

15. The DP points out (paragraphs 3.28-3.30) that the IFRS Interpretations Committee has looked at the question of accounting for contingent consideration in the past, but that the project is currently on hold, and that the IASB intends to return to the issue after it has completed its deliberations on leasing. In our view, contingent consideration, however it is measured, should be capitalised in separate financial statements as part of the cost of an investment, which reflects the overall purpose of such financial statements.

Sale or contribution of equity 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.

16. We do not agree that the IASB needs to set out specific requirements for how the acquisition of investments from entities under common control should be accounted for in separate financial statements. The DP does not provide any evidence that there is a problem with the current position, so it is not clear that there is any need to change it. Also, the implication of the discussion in the DP is perhaps that 'specific accounting requirements' would mean that such transactions would be required to be measured at fair value and subsequently tested for impairment on a regular basis. Again, this would be imposing additional costs on preparers, for no apparent benefit given the limited value of separate financial statements. The current flexibility within IFRS (and often within local European GAAPs) is a virtue, not a problem, in this context.

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.

17. We do not see any significant benefit to users from changing the current approach to accounting for equity interests in separate financial statements.

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.

18. Were it to arise in practice, we believe that a difference between the transaction price and the amount of the investment initially recognised will usually be a contribution from or distribution to the shareholder. As such, it should be accounted for through equity.

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.

19. We do not think that introducing fair value requirements for separate financial statements would pass a cost-benefit test, especially given the statements' limited usefulness.

Business combinations and separate financial statements

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.

20. We have commented previously on EFRAG's view, expressed in its 2012 DP, that there is a need to develop a uniform approach to accounting for business combinations between entities under common control (BCUCC). In our response to the DP (ICAEW REP 66/12), we stated:

> 'The discussion paper is predicated on concerns about "inconsistent accounting for BCUCC". We agree that there is indeed diversity in this area, but do not accept that this is necessarily undesirable. Quite rightly, different facts and circumstances, for example differing legal and tax regimes, lead to different accounting consequences. The situations in which these transactions occur are many and various and therefore it may often be appropriate that differences arise in the accounting used for reporting them. As such we disagree with the approach taken in the paper…'

21. We remain of the view that 'inconsistencies' in this area may appropriately reflect the diversity of the transactions. Consistent with our remarks in the rest of this response, this reflects the different purpose of separate financial statements and the need to retain flexibility to deal with local legal and regulatory requirements.

Legal mergers

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

22. Once again, this is an area in which the existing diversity of practice properly reflects the differing circumstances and differing legal requirements for 'legal mergers' – even among EU member states. It is not an appropriate topic for standardisation by the IASB or even guidance on a pan-European basis.

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.

23. As indicated in our answer to Question 3.9, we do not think that this is a topic on which there is a need to identify a 'best' approach, which should then be standardised across all transactions. Different approaches are appropriate in different circumstances.

Disclosures on distributions to equity holders in the separate financial statements

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

24. We do not believe that there is a need for any additional disclosure requirements in this area, but it is always possible for existing disclosures to be improved on a voluntary basis, and we would draw EFRAG's attention to the UK Financial Reporting Lab's project on 'Disclosure of dividend policy and capacity', which should lead to a report in 2015. This will no doubt, among other things, discuss the difficulties of prescribing useful disclosures for parent company distributable profits, but should also indicate what is current best practice. It may also look at what might usefully be disclosed at group level that would aid users of accounts, although this is likely to be even more challenging.

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.

25. This question appears to assume that there is some difference in the distributability of gains recognised in OCI that will be recycled through profit or loss rather than recognised directly through profit or loss or recognised in OCI and not subject to recycling. In fact the distinction between distributable and non-distributable profits is not that simple, so there would be no justification for such an additional disclosure. We draw your attention to the UK's guidance on distributable profits under IFRS in ICAEW Technical Release TECH 02/10, *Guidance on the Determination of Realised Profits and Losses in the Context of Distributions under the Companies Act 2006*. This shows the complex interrelationship between accounting standards and a principles-based approach to the determination of realised and distributable profits, but also demonstrates that there is no general link between presentation in or recycling from OCI and realisation.

Clarification of the current terminology under IFRS

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

26. We agree that there is probably some confusion between 'individual financial statements' and 'separate financial statements', although we are not convinced that it gives rise to serious problems for users. It would be helpful if the IASB could ensure, where there is any possibility of confusion, that it is clear when it is referring to separate financial statements.

Other issues

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.

27. As we have indicated in our comments at the start of this submission (paragraphs 1-4), it would be useful for EFRAG and its associated bodies to consider what happens outside Europe, especially in jurisdictions such as the US where they manage without requirements for separate financial statements.

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

28. And as we have also stated above (paragraphs 5-7), it would be useful for the IASB to develop a principle or principles to govern its approach to this subject, but without restricting the flexibility that currently exists for preparers to reflect their particular circumstances in their reporting.