# Removal of special purpose financial statements - consolidation requirements

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## Introduction

The AASB has issued amendments to the Australian Financial Reporting Framework and Australian Accounting Standards, which from 1 July 2021:

- Remove the ability for certain for-profit private sector entities to prepare special purpose financial statements (SPFS) for the purposes of fulfilling their annual reporting obligations to stakeholders (AASB 2020-2); and
- Replace the Tier 2 Reduced Disclosure Requirements (RDR) general purpose financial statements (GPFS) with a new Tier 2 Simplified Disclosure (Tier 2 SD) Standard (AASB 1060)

The removal of special purpose financial statements means many entities will be required to prepare general purpose financial statements and will no longer be able to 'choose' which accounting standards to apply. Historically many entities chose not to AASB 10 Consolidated Financial Statements and instead prepared 'single entity' financial statements.

This choice will no longer be available for many entities, who will find themselves required to prepare consolidated financial statements for the first time.

Before an entity can start the exercise of preparing consolidated financial statements, it will first need to determine:

- Will it choose to apply AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* or AASB 1 *First-time Adoption of Australian Accounting Standards* to its transition?
- How were its subsidiaries acquired?

## AASB 1 or AASB 108?

If an entity has material subsidiaries but did not previously prepare consolidated financial statements, AASB 2020-2 allows entities a choice:

- to transition from SPFS to Tier 2 GPFS using AASB 108, which requires full retrospective application of accounting standards, or

- to transition using AASB 1, which contains a number or exemptions and exceptions to facilitate transition.

We expect most entities will choose to apply AASB 1.

## How were subsidiaries acquired?

AASB 1 contains detailed guidance and a number of exemptions and exceptions to make the accounting for historic business combinations more straightforward, including an exemption for subsidiaries which were not previously consolidated (AASB1.C4(j)):

*"In accordance with its previous GAAP, the first-time adopter may not have consolidated a subsidiary acquired in a past business combination (for example, because the parent did not regard it as a subsidiary in accordance with previous GAAP or did not prepare consolidated financial statements). The first-time adopter shall adjust the carrying amounts of the subsidiary's assets and liabilities to the amounts that Australian Accounting Standards would require in the subsidiary's statement of financial position. The deemed cost of goodwill equals the difference at the date of transition to Australian Accounting Standards between:*

*(i) the parent's interest in those adjusted carrying amounts; and*

*(ii) the cost in the parent's separate financial statements of its investment in the subsidiary."*

At first glance, this reads as though all you need to do is prepare balance sheets at the date of transition for the parent entity and all its subsidiaries (all complying with all recognition and measurement requirements) then mechanically consolidate these. Unfortunately, first appearances can be deceiving.

Reading paragraph C4(j) again, this exemption applies to subsidiaries acquired in a past business combination. Is that how the subsidiary was acquired? Subsidiaries can be acquired in a business combination or alternatively in an asset acquisition (where the acquired entity does not constitute a business) or they can be incorporated by the entity itself.

## Subsidiaries acquired in a business combination - apply C4(j) - but there are pitfalls

For subsidiaries acquired in a business combination paragraph C4(j) will make transition easier. There are still a number of things to think about, including:

- Applying consistent accounting policies across the parent and all subsidiaries. If consolidated financial statements haven't been prepared in the past, it is possible each subsidiary has developed its own accounting policies. Whilst the transition to full recognition and measurement requirements may mean accounting policies are being reviewed, all entities in the group should adopt the same accounting policy where an accounting standard gives a choice.
- Treatment of assets (and liabilities) that have been transferred between entities within the group (and are still held by the group): Any profits or losses recorded on such transfers will need to be eliminated and the carrying amount of the asset (or liability) will need to be adjusted to reflect the original cost to the group (including adjusting any subsequent depreciation or amortisation amounts). Identifying all assets (and liabilities) that have been transferred between group entities, and what their original cost was, may be challenging depending on what accounting records the entity and its subsidiaries have kept.
- Treatment of 'negative goodwill': For subsidiaries with net assets at the date of transition that are higher than the cost of investment in the parent's books, the accounting entry will be a credit to goodwill, or 'negative goodwill'. There is no explicit guidance in AASB 1 on this, following the principles of AASB 3 gives rise to a gain on bargain purchase. We believe this should be accounted for as a credit to retained earnings in the consolidated balance sheet at date of transition.
- Testing goodwill for impairment: AASB 1 requires all goodwill that was recognised under previous GAAP be tested for impairment at transition, but there is no similar requirement for goodwill recognised as a result of applying AASB 1. However, C4(j) requires goodwill be recognised as the difference between the carrying amount of the subsidiary's assets and liabilities and the 'cost' of the subsidiary in the parent's books. As AASB 136 applies to investments in subsidiaries, on transition the cost of the subsidiary should be

tested for impairment which, effectively, means goodwill is tested for impairment on transition.

- AASB 1 requires a reconciliation of equity as at the date of transition, from equity as previously reported to equity as reported when preparing full GPFS. As part of this, disclosures are required of any impairments that have been recognised within the transition adjustments. For complex groups, it is quite possible that assets and liabilities have been transferred between entities at other than market value, which could mean value has been shifted between subsidiaries or CGUs and there may be apparent goodwill impairments and apparent gains on bargain purchase; consideration will need to be given to the disclosures required to adequately explain this.

## Subsidiaries acquired in an asset acquisition

If a subsidiary did not meet the AASB 3 definition of a business when it was acquired, then the acquisition would be treated as an asset acquisition. The AASB 3 definition of a business is:

*"An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities."*

Appendix B to AASB 3 provides guidance on what this means - a business must have inputs and processes, and the processes must (when applied to the inputs) have the ability to contribute to the creation of outputs (that is, goods and services, investment income or other income from ordinary activities).

It is not always straightforward to determine whether an acquired subsidiary meets the definition of a business when it is acquired and this analysis (whether the subsidiary was a business back when it was acquired) could be even harder many years after the event. The updated illustrative examples to IFRS 3 includes a number of examples including real estate, in-process R&D and a closed manufacturing facility as well as examples where principally intangible or financial assets are acquired. These examples all demonstrate that the analysis is often judgemental, and many past acquisitions will not be business combinations.

If the subsidiary wasn't acquired in a business combination, what then? Whilst you might think you could apply paragraph C4(j) by analogy we don't believe this is possible; AASB 1 states (in paragraph 18) that the exemptions in appendices C-E cannot be applied by analogy to other items, and this is re-iterated in Appendix C. Therefore, technically, any subsidiaries that were acquired in an asset acquisition need to be consolidated fully retrospectively.

What are the practical implications of this? For subsidiaries that were recently acquired, accounting records may be available that mean this can be done, although it may be a time-consuming exercise. And, if the work has not yet been done, entities may be running out of time.

But for subsidiaries that were acquired many years ago, there may not be any records available. What then?

In general, in an asset acquisition, the consideration paid is allocated over the individual assets and liabilities acquired based on their relative fair values, and no goodwill is recognised.

To the extent those assets and liabilities are no longer held, any acquisition adjustments that should have been made would likely since have "washed through" to retained earnings, and so no adjustments would likely be required.

However, if assets and liabilities that were "owned" by the subsidiary when it was acquired continue to be held, adjustments will be needed. This would also apply to any internally generated intangible assets that were held by the subsidiary when it was acquired and continue to have value to the entity; these would not have been reflected on balance sheet but should nonetheless have had a value attributed to them as part of the acquisition accounting exercise.

The kinds of assets that would need to be considered could include property, plant and equipment, intangible assets, and maybe other assets such as investment property, agricultural assets or exploration and evaluation assets. There may also be some long-term financial assets and liabilities that pre-date the acquisition. It is then necessary to consider how to account for these.

For many of these, the standards may require or allow them to be accounted for at fair value (with changes in fair value recognised in profit and loss). If this is the case, this may be an option; fair value would need to be determined at the

beginning of the comparative period, but it would be possible to avoid going back further. Using fair value as deemed cost may also be an option for some assets and could avoid the need for fair value accounting to continue into the future. For some assets, however, this is not an option, and an entity will need to consider how best to account for long-held assets when either the information needed is no longer available or was never even considered.

A further issue is assets (and liabilities) that have been transferred between entities (and are still held by the group) - either from a parent to a subsidiary, from a subsidiary to a parent or between subsidiaries. As discussed above, any intercompany profits or losses on these transfers will need to be eliminated and the cost of the asset (or liability) adjusted to reflect the original cost to the group. Identifying all assets (and liabilities) that have been transferred, and tracing back to find their original cost, may be challenging depending on when the transfers took place and what accounting records have been kept.

## Subsidiaries incorporated by the entity

For subsidiaries that were incorporated by the entity itself, the consolidation process is likely to be more straightforward as there will be no goodwill or fair value adjustments to account for. It will still be necessary to consider whether any assets (or liabilities) have been transferred between entities within the group (which assets (or liabilities) continue to be held by the group) and ensure these are accounted for correctly.

## What about associates and joint ventures?

As well as consolidating any subsidiaries, entities will need to identify any associates and joint ventures and ensure these are accounted for correctly.

Assuming the entity has chosen to apply AASB 1 to its transition to GPFS, it then needs to consider whether there are any exceptions or exemptions that will make equity accounting for its associates and joint ventures easier. AASB 1 extends the business combination exemption to associates and joint ventures through paragraph C5:

*"The exemption for past business combinations also applies to past acquisitions of investments in associates, interests in joint ventures and interests in joint operations in which the activity of the joint operation constitutes a business, as defined in AASB*

*3. Furthermore, the date selected for paragraph C1 applies equally for all such acquisitions."*

Whilst this exemption only applies to joint operations that meet the definition of a business, this does not seem to extend to associates and joint ventures; it appears the exemption can be applied to any historic acquisition of an associate or joint venture, whether or not it was a business.

Applying C4(j) then results in the associate or joint venture being measured (in the opening balance sheet) at its 'cost' (as recorded in the entity's single entity financial statements at that date).