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BACKGROUND PAPER

ACCOUNTING METHODS
AND
THE INTERNATIONAL ACCOUNTING STANDARDS

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Accounting Methods and International Accounting Standards

This paper is devoted to the comparison of international accounts' concepts and principals in the area of FDI with the requirements of International Accounting Standards and focuses on the differences between them. The problem on the whole is far from being resolved. This document targets only some general aspects of this complex issue.

Treatment of Direct Investment Enterprises

- The term "Foreign Direct Investment" is not used in International Accounting Standards (IAS) as they do not distinguish between residents and non-residents, though they deal with the phenomenon itself a lot.

- Related parties

- IAS has a general concept of related parties that covers concepts of control and significant influence; in line with this parents, their branches, subsidiaries, associates, SPEs, joint ventures are defined; principals of measurement and disclosure of transactions among them are described in detail. The issue is described in several Standards: IFRS 3 (International Financial Reporting Standard – new standards, released lately, are called IFRS) «Business Combinations»; IAS 24 «Related Party Disclosures», IAS 27 «Consolidated Financial Statements and Accounting for Investments in Subsidiaries»; IAS 28 «Accounting for Investments in Associates», IAS 31 «Financial Reporting of Investments in Joint Ventures», SIC 12 (Standing Interpretations Committee statement which has the same ranking as the Standards) «Consolidation – Special Purpose Entities».
- According to IAS 24, parties are related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operational decisions. Related parties invariably include holding companies, subsidiaries, fellow subsidiaries, associates, siblings, individuals, who have significant influence over the enterprise, and their relatives, key management personal and their relatives as well as other enterprises over which above mentioned persons are able to exercise significant influence. The definition is difficult to follow and it is recommended to determine the nature of the relationship not on the sole basis of legal aspects.

- Subsidiaries

- According to IAS 27, an enterprise that is controlled by another enterprise (the parent) is the subsidiary. IAS doesn't accept 50 percent of voting rights as the sole criterion – control may exist even in cases where an enterprise owns little or none of the controlled entity's equity (SIC12.9, IAS 27.6). This is the only difference in definition of subsidiaries with the BOP concept (the operational definition).

- Associated enterprises

- According to IAS 28, an associate is an enterprise in which the parent owns at least 20 percent of the voting power and on which it has a significant influence. Because the significant influence criterion is difficult to specify, only ownership of at least 20 percent of voting rights gives rise to significant influence. The quantitative approach is used also as in the operational definition of FDI in BPM5, which proved to be practically worthwhile. This is not only an important difference compared with the definition of a subsidiary which doesn't require the holding of shares, but can also be considered as an argument in favour of changing the 10 percent threshold to 20 percent: IAS 28.4 states that no significant influence exists if the voting power is less than 20 percent, unless this influence can be clearly revealed.

- Joint ventures
- According to IAS 31, a joint venture exists when two or more venturers perform an economic activity under joint control. Joint control is a contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing the control (the venturers) (IFRS 3,C10). This mandatory requirement of the established contractual arrangement, which ensures that no single venturer is in a position to control the activity unilaterally, could be added to the joint venture definition given in Issues Paper 4# "Mergers and Acquisitions" prepared by OECD.

- Apart from mentioned nuances the definitions of direct investment relationship in Annotated Outline (AO) and in IAS are close per se. With the accounting principals everything is much more complicated.

Consolidation of investments in subsidiaries
- For someone who knows BOP methodology, the consolidation of investments in subsidiaries can look similar to the BOP compilation of countries' unions. First of all one should make sure that both a parent and a subsidiary follow the same accounting principals (IAS) in their separate financial statements. The second step is to identify in these statements bilateral assets and liabilities, bilateral transactions, revenue and expenses from these transactions and eliminate them. Also all equity and reserves of the subsidiary should be removed from its financial statements. Then the residuals should be summarized item by item in the consolidated statement. Accordingly, 100 percent of the subsidiary's assets and liabilities other than bilateral are included, irrespective of the ownership interest held in the subsidiary. The last step is to recognise goodwill and minority interest in the consolidated balance sheet. Above is a short description of the full consolidation method.
- Goodwill
- According to IFRS 3.51-53, goodwill is an asset and is measured as an excess of the cost of the business combination for the parent over his interest in the subsidiary's net assets measured at fair value as at the acquisition date. Goodwill acquired in a business combination represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised. In other words, goodwill is measured as a residual cost of the business combination.
- According to IFRS 3, when the cost paid by the parent is less than his interest in the value of net assets of the subsidiary (e.g. because of expectations of future losses) negative goodwill is no longer recognised as it was under withdrawn IAS 22. Now IFRS 3 requires the acquirer "to reassess" the net fair value of the acquiree's identifiable assets and liabilities and recognise in profit or loss any excess remaining after that reassessment (IFRS 3.56).
- A radical change refers to the recording of contingent liabilities. Contingent liabilities were, in accordance with IAS 22, subsumed within the amount recognised as goodwill or negative goodwill. In line with discontinuance of negative goodwill accounting, IFRS 3 requires a separate recognition of acquiree's contingent liabilities in consolidated reporting in balance sheet, provided their fair value can be measured reliably. To determine fair value of such liabilities one shall use the amounts that a third party would charge to assume those contingent liabilities. Such an amount shall reflect all expectations about possible cash flows and not the single most likely or the

expected maximum or minimum cash flow (IFRS 3.B16). In all other cases contingent liabilities are off-balance sheet items.
- Can goodwill appear when equity of subsidiary is bought at market price in an active market during one day (i.e. all shares at the same price)? Yes, it can. Goodwill when recognised (a debit entry) is an arithmetic difference balancing the cash flow (a credit entry) and the estimate of net assets of the subsidiary measured at fair value at the moment of its inclusion in the consolidated statement (a debit). Firstly, market value of an enterprise depends not only on the value of its net assets, secondly an estimate of net assets at fair value can't but reflect all conventions used in IAS to value different balance sheet items kinds and categories.
- Goodwill is recognised only in the consolidated balance sheet, it is not evaluated in a separate balance sheet of the parent. In the parent's balance sheet an amount equal to goodwill relating to the subsidiary is an integral part of "Investments in subsidiaries" line item.
- Minority interest
- At a minimum, a group includes one parent and one subsidiary. In addition to the parent, minority shareholders should be presented both in the income statement and balance sheet, likewise under the consolidation procedure all equity of a subsidiary was removed from the balance sheet. Minority interest reflects which portion of the profit or loss and net assets of a subsidiary is attributable to equity interests that are not owned by the parent, but rather by third-party investors. According to IAS 27.15,26, the minority interest should be presented in the balance sheet between liabilities and equity. Thus, the minority interest may be viewed as an intermediary capital category. The proposed approach is to present the minority interest in the equity of the group.
- Lack of FDI in consolidated statements
- If a parent and a subsidiary are located in different countries and there's an FDI relationship between them, and the parent prepares a consolidated financial balance sheet, BOP compilers can hardly use it in their work as a data source on FDI because the latter are excluded from it. If this approach is correct, the consolidation techniques, evaluation of goodwill and other things are of pure cognitive value for BOP compilers and could be probably ignored in the Annotated Outline.

Accounting of investments in subsidiaries in a separate financial statement.
- IAS focus attention not only on consolidation but also on accounting of investments in subsidiaries in separate financial statements of the parent.
- A single line item "Investments in subsidiaries" is introduced in the parent's statement.
- Valuation of transactions
- In accordance with IFRS 3.24, the acquirer shall measure the cost of business combination as the aggregate of: (a) the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer (if any) , in exchange for control of the acquiree; plus (b) any costs directly attributable to the deal (professional fees paid to accountants, legal advisers, valuers and other consultants to effect the combination).
- These costs are excluded from valuation of financial instruments in international accounts because both debtors and creditors should record the same amount for the same financial instrument (*AO, para. 3.13).* The IAS approach corresponds to the accounting of intangible assets and fixed assets and provides accrual accounting of

services in the books. Evidently different methods are recommended in IAS and AO with respect to financial services recording.
- The (a) component of the costs of investments is measured at fair value that is determined in accordance with IAS 39 “Financial Instruments: Recognition and Measurement.” A longstanding issue of fair value application within the international accounts is raised in Chapter 3 of AO “Accounting Principals”. It should be further explained in AO that valuation based on IAS (always?) includes transaction costs at initial recognition and also at each subsequent date for instruments measured at amortized cost as these costs are amortised together with amortization of the instrument using the effective interest method. Subsequent recording of held for trading and available-for-sale financial instruments accounted at fair value is done without regard initial transaction costs or commission for sale. Another technical problem that can hardly be settled is that IAS 39.AG 72 recommend that different market quotations are applied as of recognition date and subsequent dates: the current bid price is the appropriate quoted market price for an asset held or liability to be issued and the asking price is to be used for an asset to be acquired or liability held.
- The IAS 39 latest version has moved closer to application of market value, where possible, clarifying that the best evidence of fair value is provided by published price quotation in an active market, except in rare circumstances. When market is thin, the price of the most recent transaction, the published prices of the similar instruments, discounted cash flow analysis and other valuation techniques should be used as basis for estimation. The obtained estimate is expected to reflect how the market could price the instrument (IAS 39.AG71-75).
- But this positive change doesn’t eliminate the problem of different evaluation standards, which can be applied after initial recognition, in accordance with IAS 39, to the same instrument (a) if it is classified in different categories of financial assets/liabilities; and (b) dependant on what balance sheet - creditor’s or debtor’s - it is recorded in.
- According to IAS 39 the initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides foundation for estimating the fair value of the financial instrument. Consequently, at the acquisition of a subsidiary the investment of a parent is recorded at market price. This means that this investment measurement meets the BOP accounting principals and can be transferred from the books to BOP with the exception of transaction costs.
- Time of recording
- Time of recording is the date on which the acquirer effectively obtains control of the acquiree (IFRS 3.25). As BPM5 para.123 states, that transactions in financial items are considered to have taken place when both creditor and debtor have entered the claim and liability in their books, respectively the date of control transfer (not transfer of money or legal ownership) relates to timing of BOP entries.
- Valuation of positions and other changes
- When a business combination is achieved in stages by successive share purchases the acquisition date is the date on which the acquirer obtains initial control of the acquiree. The cost of the combination is the cost of the individual transactions.

<u>Example</u>. Company B is a listed company and its equity consists of 1300 shares. Company A bought the shares of B at market prices in three stages: on June 30, 2003 –100 shares at 5 per share; on September 30,2003 – 100 shares at 7, and on November 30, 2004 – 500 shares at 9. The share’s market price as at December,31 2003 was 8, at December 31, 2004 –10.

The first and the second transaction is 7.7% each of total number of shares that is less than 20%, so both should be recognised at the date of transaction in accordance with IAS 39 as "Available-for-sale financial assets" and revalued as at the end of the year at fair value.

	Debit	*Credit*	
June 30, 2003			
Available-for-sale assets	500		
Cash		500	
September 30,2003			
Available-for-sale assets	700		
Cash		700	
December 31,2003			
Available-for-sale assets	400		
Revaluation reserves		400	=100*(8-5)+100*(8-7)

After the purchase of 500 shares the investment in company B should be reclassified in "Investments in subsidiaries", recognised at purchase price. Therefore the revaluation reserves are to be eliminated. November 30 is an acquisition date for investments in subsidiaries.

November 30, 2004			
Available-for-sale assets	4500		
Cash		4500	
Revaluation reserves	400		
Available-for-sale assets		400	
Investments in subsidiaries	5700		=500+700+4500
Available-for-sale assets		5700	

On *December 31,2004* the market price changes, but no revaluation is made, as the investments in subsidiaries are recognised at cost, not at fair value.

- What does the example illustrate? The recording of available-for-sale assets flows and positions in accordance with IAS 39 agrees with the portfolio investment recording in AO where everything is registered at market value. Initial accounting of investments in subsidiaries (IFRS 3) agrees with the capital contributions recording in AO as in both systems market prices are used. At the same time IFRS 3 treatment of investments in subsidiaries stocks at each balance sheet date subsequent to the date of acquisition doesn't coincide with direct investment positions treatment in AO as holding gains/losses are not taken into account. Besides, the accounting of changes in instruments classification (between portfolio and direct investment) in IAS and AO is conducted differently – since other changes in volume are registered in IAS at cost of instruments and in AO at market price as at the date of the reclassification (the latter is not said in AO directly - there's just a declaration in Chapter 8 "Other Changes in Financial Assets and Liabilities Account", para.8.9 to discuss general valuation principles).
- In general, there are more discrepancies than coincidences in the accounting rules as regards FDI in IAS and AO.
- In their future development, which is being discussed, IAS 27, IAS 28, and IFRS 3 will be oriented at the fair value option (and published quotations in particular) for a separate statement of an investor in subsidiaries, joint ventures and associates. As a

supplementary information, the investment in associates at fair value shall be disclosed.

- Recording of income and other capital

- According to IAS, intercompany debts are normally treated similar to debts vis-à-vis unrelated parties in separate financial statements, they are not combined in one item with investments in equity, and their accounting depends on the category they relate to (IAS 39).
- Practical attribution of IAS is evidence to the following. When a subsidiary receives a subordinated or participation loan carrying low or no interest, this loan is recognised at discounted price at the market rate of interest for a similar loan and is amortized in accordance with IAS 39; simultaneously, profit related to this transaction can be recognised as capital contribution from the parent. In its turn, the parent can recognise this loan in "Investments in subsidiaries" line item. If a subsidiary provides a low interest loan to its parent, the former recognizes the discounted amount as a loan and recognizes a reduction in equity; the latter shows the reduction of investments in subsidiaries (IAS 28.7).
- Income accounting in IAS and AO is very close to each other. The cross references to the manuals which are given in AO para.10.39 seem very helpful for the interpretation of retained earnings and reserves in IAS. The main problem with retained earnings, which is passed over in silence, is that they are present only in income statement and in balance sheet of a subsidiary and are not recorded in financial statements of a parent (because of transaction costs method) and in consolidated accounts (because inter-group operations are excluded). Dividends are easily identifiable in separate financial statements of both a parent and a subsidiary.
- Income on other capital is not presented separately in IAS and should be distinguished from income on other instruments.

Accounting of investments in associates

- According to IAS 28, interests in associates should be accounted for in consolidated financial statements using the equity method. Under the equity method, interests in associated enterprises are recorded at purchase cost (purchase method) at the time the significant influence is established (that is similar to subsidiaries). All other accounting rules are in contrast to those applicable to the subsidiaries. Interests in and results from associates should be shown in separate item in the consolidated balance sheet or income statement. At balance sheet date subsequent to the date of acquisition carrying investment is to be adjusted with the proportionate results of the associate activity. Consequently, the associate's proportionate net income/loss are included in the net income in the consolidated financial statements. Accordingly, the distribution of dividends has no impact on the net income reported in these statements, but reduces the carrying amount of the investment (28.3,6).

Example. On January 1, 2002, parent enterprise acquires a 20% interest in the associate A for an amount of 500. A makes a profit of 100 in 2002. In 2003 A makes a profit of 50 and distributes the previous year's profit of 100.

Purchase cost of interest	500
+ Proportionate profit of 2002	20
Interest in A at December 31, 2000	520
+ Proportionate profit of 2003	10
- Dividends for 2002	20
Interest in A at December 31, 2003	510

- Goodwill is included in the carrying amount of an investment of an associate, but is not separately recognised (IAS 28.33). The entire amount of the investment is tested for impairment, by comparing its recoverable amount with its carrying amount.
- Minority interests are not reported (as we are a minority now).
- Intercompany assets and liabilities are not eliminated (as they were not incorporated in the consolidated accounts).
- According to the equity method, the determining of parent's interests in associate is possible also on the basis of proportionate net assets of this associate as of the reporting date.
- In separate financial statements of a parent investments in associates are shown under a separate item and can be accounted for using the equity method or the purchase method. If the first method is applied the entries in consolidated and individual reporting are the same, but the accounting of investments in subsidiaries and associates, though included in the same item "Investments in subsidiaries and associates", is different.

Investments in joint ventures
- According to IAS 31, jointly controlled entities (joint ventures) are included in the consolidated financial statements through the proportionate consolidation that corresponds to the consolidation of subsidiaries, except that the enterprise's assets, liabilities, income and expenses are included on a proportionate basis. Minority interests are not recognised. As the assets and liabilities of joint ventures are only proportionally included in the added balance sheet, only the respective proportion of the group company's receivables and liabilities towards joint venture can be eliminated. The part of the group company's receivables and liabilities relating to the shares in the joint venture of third parties is not eliminated. This also applies to the elimination of income and expenses. The investments should be shown under a separate balance sheet item. For a separate financial statement no recommendations are presented.

Thus, according to IAS, at the moment of initial recognition for all kinds of FDI relationship the same valuation method is used, but at any subsequent date the approaches used differ: for investment with share of 10-20 percent, fair value is used; for associates with holdings of 20-50 percent purchase cost plus proportionate profit is applied; for subsidiaries purchase cost is recommended.

Points for discussion
Do DITEG members view a difference in considerable portions of IAS and AO basic accounting principals as a serious problem for statistics?

Do DITEG members share the opinion that consolidated financial statements are of low practical value as a FDI data source? If not, is further examination of approaches and rules devoted to consolidation needed?

Do DITEG members agree that separate financial statements of related parties are more useful for the international accounts' compilers and should be subject of much description in Compilation Guide?

Is it appropriate to take into account the latest developments in IAS when different approaches are considered at DITEG meetings?

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