IFRS 1: Carve-out Financial Statements

Extract, IFRS Discussion Group Report on Meeting – September 11, 2014

IFRSs do not include specific guidance on the preparation of carve-out financial statements. However, *The Conceptual Framework for Financial Reporting* and some standards include information that may be relevant to the preparation of such financial statements.

Fact Pattern:

Entity ABC Corp. plans to spin off a line of business that is not a legal sub-group and needs to prepare financial statements for this line of business. ABC Corp's date of transition to IFRSs is January 1, 2010 and the line of business was part of ABC Corp's operations at that date. The carve-out financial statements of the line of business are being prepared for the years ended December 2014 and 2013.

For purposes of this discussion, carve-out financial statements are the financial statements of one or more components of a larger entity that are not part of a legal sub-group. This discussion assumes that the financial statements will comply with IFRSs and, therefore, will include a statement of compliance with IFRSs as issued by the IASB. The discussion does not address any regulatory considerations required to be taken into account if the financial statements were included in a regulatory filing.

Issue: Can IFRS 1* First-time Adoption of International Financial Reporting Standards *be applied to the carve-out financial statements of the line of business when ABC Corp was already in full compliance with IFRSs?

View A – Yes, IFRS 1 may be applied.

IFRS 1 may be applied when general purpose financial statements are prepared for a new reporting entity. In accordance with paragraph 3(d) of IFRS 1, since the line of business (i.e., the new reporting entity) did not present financial statements for previous periods separate from those of ABC Corp, the carve-out financial statements would be considered its first IFRS financial statements.

This view is also supported by the exemption provided in paragraph D16 of IFRS 1, relating to when a subsidiary transitions to IFRSs later than its parent. The exemption reinforces the principle that IFRS 1 is applicable, even though the subsidiary was included in the parent's transition to IFRSs as part of the consolidated financial statements. Although the line of business in the fact pattern is not a legal subsidiary of ABC Corp, it is controlled by ABC Corp. until such time as it is sold or spun off to third parties.

View B – No, IFRS 1 may not be applied.

It may be argued that carve-out financial statements are not being prepared for the first time because the reporter was extracted from an entity that has already transitioned to IFRSs. Therefore, the carve-out financial statements are not those of a first-time adopter. Further, absent any IFRS definition of "entity", it may be argued that a component of an entity that is not a legal sub-group isn't an entity as envisaged in IFRS 1.[1] The exemption in paragraph D16 isn't relevant as it relates to subsidiaries, associates and joint ventures that would themselves be entities.

View C – The application of IFRS 1 to carve-out financial statements depends on the particular facts and circumstances.

In cases such as the one at hand, where the component for which carve-out financial statements are being prepared isn't a legal sub-group of the larger entity, the application of IFRS 1 depends on whether the facts and circumstances support that a new reporting entity has been created. Factors to be considered include whether the carve-out financial statements have necessitated such adjustments as corporate cost allocations, the allocation of corporate assets and the creation of intercompany accounts.

The Group's Discussion

The majority of Group members supported View A, that IFRS 1 may be applied. Moreover, some Group members commented that IFRS 1 must be applied if the new reporting entity has not presented IFRS financial statements in previous periods. Some Group members noted that even if IFRS 1 is applied, the use of the parent company's carrying amounts would be permitted in accordance with paragraph D16 of IFRS 1. One Group member cautioned that some jurisdictions specifically prohibit the application of IFRS 1 in circumstances such as the one at hand.

Other Group members expressed sympathy for View B, noting that IFRS 1 is meant to assist entities in transitioning from their previous accounting framework to IFRSs. If the historical information of the entity is already accounted for under IFRSs, the relevancy in applying IFRS 1 should be questioned. One Group member pointed out that, in looking forward to a time when all entities have been applying IFRSs for many years, applying IFRS 1 to carve-out financial statements produces rather strange results.

One member thought View C could be supported because the facts and circumstances should be analyzed to determine if a new reporting entity has been created.

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1 It should be noted that the IASB's March 2010 Exposure Draft, "Conceptual Framework for Financial Reporting – The Reporting Entity," discusses the concept of a reporting entity and specifies the circumstances in which a portion of an entity could qualify as a reporting entity.

If IFRS 1 is applied, most Group members expressed the view that all requirements of the standard should be applied, including, for example, the presentation of an opening statement of financial position. A possible exception is providing reconciliations to previous GAAP, which may not be applicable to carve-out financial statements that have no previous GAAP basis of reporting.

The Group's discussion raises awareness about this item. No further action was recommended on this item.