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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **3 November 2006, London**

Project: **De-mergers and Other in-specie distributions (Agenda Paper 9)**

BACKGROUND INFORMATION

1. The IFRIC has been asked to provide guidance on how to account for de-mergers and other in-specie distributions <u>in the financial statements of the entity making such distributions to its shareholders</u>.

2. IFRSs do not define 'de-mergers' nor 'in specie distributions'. These terms are generally used to describe the circumstances when an entity divests itself of some of its assets and/or businesses and transfers them to its shareholders by way of a dividend in kind. The most common form of distribution is in the form of shares in the business transferred[1]. Transfers to existing shareholders of an entity's subsidiaries or businesses are generally referred to as de-mergers.

[1] Assets could be transferred directly to a shareholder, but this is only feasible if the assets are divisible or the distribution is to one shareholder.

3. Two examples of de-mergers are as follows:

Example 1: Individual shareholders A and B own 60% and 40% equity interests in Entity X respectively. Entity X has two wholly-owned operating subsidiaries, Subsidiary A and Subsidiary B. Individual shareholders A and B decide to separate the two businesses into two groups. Entity X distributes its equity interests in Subsidiary B to shareholders A and B in proportion to their equity interests in Entity X.

Example 2: Same facts as Example 1 except that Entity X distributes its equity interests in Subsidiary B to shareholder B only. After the de-merger, shareholder A owns Business A and shareholder B owns Business B.

4. Accounting for de-mergers and other in-specie distributions is not addressed specifically in IFRSs. Three possible alternatives of accounting for in specie distribution are identified in practice:

- distributions recorded at the carrying amounts of the assets or businesses distributed;
- distributions recorded at the fair values of the assets or businesses distributed, with any difference between the fair values and the carrying amounts of the assets or businesses recognised in profit or loss; and
- distributions recorded at the fair values of the assets or businesses distributed, with any difference between the fair values and the carrying amounts of the assets or businesses recognised in equity.

5. In view of the above three alternatives, the following two questions are identified:

(i) on what basis should in-specie distributions be measured (i.e. at fair values or at carrying amounts)? and

(ii) if in specie distributions are measured at amounts other than the carrying amounts of the assets or businesses distributed, where should the resulting difference be recognised (i.e. in equity or in income statement)?

6. [Paragraph omitted from observer note].

PURPOSE OF THIS AGENDA PAPER

7. The staff notes that the proposed amendments to IAS 27[2] might address how to account for some de-mergers (in particular those involving ownership interests of a subsidiary). This agenda paper sets out the relevant requirements in the proposed amendments to IAS 27.

8. In the light of those proposed amendments to IAS 27, the staff would like to ask the IFRIC whether clarification from the Board should be sought before performing further analysis. That is to say, the aim of this agenda paper is not to recommend which of the above three alternatives is more appropriate. Rather, it seeks clarification on how the IFRIC would like to proceed with the issue.

REQUIREMENTS IN THE PROPOSED AMENDMENTS TO IAS 27

9. In determining how to account for de-mergers and other in specie distributions in the financial statements of an entity making distributions to its shareholders, the staff believes that it is necessary to address issues from the perspective of the entity (not from the perspective of the shareholders that receive dividends in kind).

10. Under the proposed amendments to IAS 27, the accounting for changes in the parent's interest in a subsidiary in the consolidated financial statements of the parent depends on whether the parent has lost control over the subsidiary concerned.

11. Paragraph 30A of the proposed amendments to IAS 27 states:

> 'Changes in the parent's ownership interest in a subsidiary after control is obtained that do not result in a loss of control shall be accounted for as transactions between equity holders in their capacity as equity holders. No gain or loss shall be recognised in profit or loss on such changes. The

[2] Exposure Draft of Proposed Amendments to IAS 27 *Consolidated and Separate Financial Statements*, issued in June 2005.

carrying amount of the non-controlling interest shall be adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between the amount by which the non-controlling interest is so adjusted and the fair value of the consideration paid or received, if any, shall be recognised directly in equity and attributed to equity holders of the parent.'

12. Paragraph 30C of the proposed amendments to IAS 27 states:

> 'If control of a subsidiary is lost, whether through a sale of ownership interests in that subsidiary by the parent or members of the group or **<u>through other means</u>**, any resulting gain or loss shall be recognised in profit or loss. That gain or loss shall be measured as the difference between:
>
> (a) the aggregate of the fair value of the proceeds, <u>if any</u>, from the transaction or event that resulted in the loss of control and the fair value of any investment remaining in the former subsidiary at the date control is lost; and
>
> (b) the aggregate of the parent's interest in the carrying amount in the consolidated financial statements of the former subsidiary's net assets immediately before control is lost, including the parent' share of gains or losses related to the former subsidiary recognised in consolidated equity.'

13. According to the IASB Work Plan as at 30 June 2006, a revised IAS 27 is <u>expected to be issued in the second half of 2007</u>.

14. In the staff's view, the proposed amendments to IAS 27 address how to deal with changes in the parent's ownership interest in a subsidiary in the consolidated financial statements of the parent, <u>regardless of the reasons for the changes</u>. Paragraph 30C of the proposed amendments to IAS 27 suggests that control of a subsidiary can be lost through a sale, or other means. Therefore, <u>if the words in the proposed amendments are carried through to the final standard</u>, the staff believes that some de-mergers (in particular those involving ownership interests of a subsidiary) are addressed.

15. The staff is not sure whether the above interpretation reflects the intention of the Board when it developed the proposed amendments to IAS 27.

STAFF RECOMMENDATION

16. The staff recommends that, before carrying out further analysis on how de-mergers and other in specie distributions should be accounted for, the IFRIC should ask the Board whether the proposed amendments to IAS 27 are intended to address de-mergers involving ownership interests in a subsidiary.

17. The staff acknowledges that the proposed amendments to IAS 27 may relate to some de-mergers only (those involving ownership interests of a subsidiary). The accounting for other distributions in specie (i.e. distributions of assets (other than ownership interests of a subsidiary)) still needs to be addressed. However, the staff believes that the Board's clarification is important because the accounting for de-mergers involving ownership interests of a subsidiary may have implications for the accounting for other in specie distributions.

18. If the Board agrees that the proposed amendments to IAS 27 cover de-mergers involving ownership interests of a subsidiary, the staff believes that the Board should clarify how the gain or loss should be measured. Paragraph 30C of the proposed amendments to IAS 27 requires any gain or loss to be calculated based on the difference between the fair value of the proceeds (if any) and the carrying amounts of the parent's interest in the carrying amount in the consolidated financial statements of the former subsidiary's net assets immediately before control is lost. However, for in specie distributions, generally no proceeds will be received from shareholders who receive the distributions. In other cases in which capital of the entity making in specie distributions are reduced, the Board should also clarify whether the transaction should be treated as a share buy-back in accordance with paragraph 33 of IAS 32.

QUESTION TO THE IFRIC

19. Does the IFRIC agree with the staff recommendation? If not, what is the next step the IFRIC would like the staff to take?