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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **22 February 2007, London**

Project: **Business Combinations II**

Subject: **Proposed Amendments to IAS 27/Proposed Replacement of ARB No. 51: Multiple Arrangements that should be accounted for as a single transaction or arrangement (Agenda Paper 2C(ii))**

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1. Both NCI EDs require that if control of a subsidiary is lost any resulting gain or loss shall be recognised in profit or loss. The gain or loss is measured as the difference between (a) the aggregate of the fair value of the proceeds 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 statements of the former subsidiary's net assets immediately before control is lost. In contrast, changes in ownership interest of a subsidiary after control is obtained that do not result in a loss of control are accounted for as transactions between equity holders in their capacity as equity holders (that is, no gain or loss is recognized in earnings).

2. During initial deliberations, the Boards expressed concerns that the proposals could give rise to opportunities to structure transactions to achieve a particular accounting outcome. BC9 of ED IAS 27 states:

> For example, would an entity be motivated to structure a transaction or arrangement as multiple steps to maximise gains or minimise losses if an entity was planning to dispose of its controlling interest in a subsidiary? Consider the following example. An entity P (Parent) controls 70 per cent of entity S (Subsidiary). P intends to sell all of its 70 per cent controlling interest in S. On 31 December the fair value of S as a whole is CU 12,000 and its carrying value in consolidated financial statements is CU 8,000. P could initially sell 19 per cent of its ownership interest in S without loss of control and then, soon afterwards, sell the remaining 51 per cent interest and lose control. Alternatively, P could sell all of its 70 per cent interest in S in one transaction. In the first case, the gain on the sale of the 19 per cent would be recognised directly in equity, whereas the gain from the sale of the remaining 51 per cent interest would be recognised in profit or loss, resulting in a recognised gain of CU 2,040. In the second case, the whole amount of the gain or loss on the sale of the 70 per cent interest would be recognised in profit or loss resulting in a recognised gain of CU 2,800.

3. The Boards observed that the opportunity to conceal losses through structuring would be mitigated by the requirements of IAS 36 *Impairment of Assets* and IFRS 5 *Non-current Assets held for Sale and Discontinued Operations* and/or FASB Statement No. 142, *Goodwill and Other Intangible Assets*, and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. However, the Boards also decided to incorporate additional guidance about when multiple arrangements should be accounted for as a single arrangement in their NCI EDs. Paragraph 30F of the IASB ED (see also paragraph 29 of the FASB ED) states:

> Control of a subsidiary may be lost in two or more transactions or arrangements. An entity shall account for each such transaction or arrangement separately unless circumstances indicate that the transactions or arrangements are part of a single transaction or arrangement. In determining whether to account for the transactions or arrangements as a single transaction or arrangement an entity shall consider all of the terms and conditions of the transactions and arrangements and their economic effects. If one or more of the following indicators are present, the transactions or arrangements are to be accounted for as a single transaction or arrangement:
>
> (a) they are entered into at the same time or as part of a continuous sequence and in contemplation of one another.
>
> (b) they form a single arrangement that achieves, or is designed to achieve, an overall commercial effect.

(c) the occurrence of one transaction or arrangement is dependent on the occurrence of the other transaction(s) or arrangement(s).

(d) one or more of the transactions or arrangements considered on their own is no economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

The transactions or arrangements are to be accounted for separately if the entity can demonstrate clearly that they are not parts of a single transaction.

4. Most constituents agreed that transactions that are best viewed together should be accounted for as if they are one transaction. Some respondents expressed concerns about how the NCI EDs propose to implement the requirement. The staff analyses these concerns below.

The need for such guidance indicates a weakness in the proposals

5. Some constituents stated that the need for guidance on when multiple arrangements should be accounted for as a single arrangement indicates a conceptual weakness in the NCI EDs. They also stated that such guidance would be unnecessary under the other alternative accounting models. For example Mazars wrote:

> [Our proposed] treatment would eliminate the need for indicators that multiple arrangements are in fact a single one … The necessity for the Board to clarify these elements demonstrates that the accounting solutions concerning transactions with non-controlling shareholders without loss of control are not sound enough to avoid various interpretations and abuses. We thus insist […] that such gains or losses recognised directly to equity should be recycled to profit or loss at the time when the control is lost.

6. The staff notes that the achievement or loss of control of a subsidiary is a fundamental change in the nature of the investment because by obtaining (losing) control of a subsidiary, the parent becomes (is no longer) responsible and accountable for all of the subsidiary’s assets, liabilities and activities, regardless of the percentage of its ownership in the subsidiary. The achievement or loss of control is therefore different from changes in ownership interests of a subsidiary after control is obtained.

7. The staff acknowledges that guidance on multiple arrangements would be unnecessary under some of the other accounting alternatives (partial purchase method; recognising any gains or losses in income regardless of whether the transaction resulted in a loss of control or not; recycling upon loss of control the equity effects of earlier transactions between controlling and non-controlling interest which did not result in a loss of control). However, the staff believes that this does not necessarily mean that those models are conceptually superior. It merely indicates that the other accounting models provide similar accounting results for conceptually different types of transactions.

The NCI EDs are not the right place to address the issue of linkage transactions

8. Paragraph 35 of the IASB's conceptual framework contains principle-based guidance for those transactions when the substance of a transaction or other event is not consistent with that which is apparent from its legal or contrived form. The Boards' joint Discussion Paper *Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information* no longer includes substance over form as a qualitative characteristic because the Boards concluded it would be redundant. The Boards observed that the qualities of reliability and representational faithfulness leave no room for accounting representations that subordinate substance to form.

9. Some constituents argued that the qualitative characteristics in the Boards' conceptual frameworks would already fully capture the issue of multiple arrangements and that no additional guidance on a standard level is needed.

10. Other constituents suggested that the Boards should consider the issue of linkage transactions more broadly, rather than only in respect to the loss of control over a subsidiary.

11. For example, Flick Gocke Schaumburg wrote:

> We believe that this provision should not be limited to the disposal of interests in a subsidiary, but that it should cover all kind of transactions. Moreover, this issue is already addressed by the "substance over form" principle in the framework.

12. The staff acknowledges that the qualitative characteristics of relevance and representational faithfulness already imply that sometimes, depending on the economic facts and circumstances, multiple transactions should be accounted for as a single transaction or arrangement. However, during initial deliberations, the Boards were concerned that the guidance in the Boards' conceptual frameworks might not be sufficient to prevent structuring opportunities arising from their decision that a gain or loss on the disposal of a subsidiary should be recognised only when that disposal results in a loss of control. The Boards decided therefore that the general guidance in their conceptual frameworks should be supplemented by standards-level guidance on multiple arrangements.

13. The staff agrees with constituents that it would be better if the Boards were able to develop broad principles for linkage transactions that applied in various situations rather than just for the loss of control over a subsidiary. The staff notes that the proposed guidance on multiple arrangements was derived from the IFRIC's project on linkage transactions. In paragraph BC12 of the IASB ED the IASB noted that if it or the IFRIC develops a general statement on linkage to address the circumstances when two or more transactions or arrangements should be treated as a single transaction or arrangement, that pronouncement might replace the proposed guidance. Neither the IASB nor the IFRIC has meanwhile issued such general guidance and it is unlikely that the Boards or their Interpreting Bodies will issue such guidance before the final NCI standards are issued. Hence, the staff believes that it is better to provide limited guidance in the final NCI standards rather than none at all.

The NCI EDs should provide more principle-based guidance on multiple arrangements.

14. Some constituents argued that the proposed guidance on multiple arrangements should be less strict and more principle-based. Several constituents noted that they could still envision transactions that could be structured around the additional guidance. However, they did not provide examples of those transactions.

15. For example, PwC wrote:

> [I]f the Boards decide to retain their proposed model, we believe such guidance is necessary, but recommend that the guidance should be principles-based. […] The indicators (a) - (d) could be retained as factors to consider in making a determination, but the absence or presence of such indicators should not be determinative.

16. The staff agrees with those constituents who stated that the guidance in the NCI EDs seemed overly strict and not principles-based. That is, the following wording in the NCI EDs made the guidance seem more like a rule than an indicator:

> If one or more of the following indicators are present, the transactions or arrangements are to be accounted for as a single transaction or arrangement

17. As such, the staff proposes to modify the guidance so that it is understood that they are indicators rather than requirements. The staff's suggestions are included later in this memo.

Requests for Examples Rather Than Indicators

18. Some constituents suggested that the standard should include examples rather than indicators for when multiple transactions should be treated as a single transaction or arrangement, but that those examples should not be considered a closed list.

19. The staff believes that the Boards have chosen to provide indicators rather than examples in order to provide principle-based guidance on when multiple arrangements should be accounted for as a single transaction or arrangement. The staff believes that providing indicators is clearer and more understandable than providing a list of examples. The indicators are also more principles-based, can be applied to a variety of situations, and preferable to providing what could be an endless list of examples to try to capture every possible structuring arrangement.

20. In addition, the Boards have decided to provide indicators in other projects. For example, the Boards have decided to provide indicators in the business combination standard for deciding which assets and liabilities are part of the business combination accounting and which are separate transactions. The IASB has also decided to try to develop indicators in the IAS 37 project to deal with

element uncertainty and the FASB also used the IFRIC linkage guidance to develop linkage principles in its liabilities and equities project.

21. The staff recommends to emphasise further the principles-based character of the provided indicators in the drafting of the final NCI standards. The staff proposes to modify the guidance to clarify that the list of indicators is **not intended to be comprehensive** and that they represent only indicators that a multiple arrangement **may** have to be accounted for as a single transaction or arrangement (see below).

The NCI standard should provide additional guidance for accounting for multiple arrangements

22. Some constituents requested additional application guidance for the following:

    a. The point at which the single accounting entry should be recorded.

    b. Determining the fair value of consideration received when multiple arrangements are accounted for as a single transaction or arrangement.

    c. Accounting for individual transactions if the series of transactions is partially-complete at a period end.

    d. Accounting for complex single-agreement structures, likely to be seen in practice, such as agreements that involve a forward or an option.

23. For example, Deloitte wrote:

> Additionally, the “Illustrative Examples” that accompany the proposed amendments should provide examples of how to apply the paragraph 30F criteria to real-life transactions, and the resulting accounting treatment. For instance, an example illustrating the accounting treatment of the following fact pattern would be helpful: two transactions, which together result in loss of control, are determined to be part of a single arrangement, and the transactions occur in different reporting periods. Likewise, examples should be provided on the required accounting for complex single-agreement structures likely to be seen in practice, such as agreements that involve a forward or an option. For illustrative purposes, assume an 80 percent controlling interest enters an agreement to sell 29 percent of its controlling to the non-controlling interest on July 1, 20XX, coupled with (1) a forward to sell the remaining 51 percent controlling interest six months from the initial sale date or (2) an American option to put

> the remaining 51 percent controlling interest to the non-controlling interest (the option writer) for a term of one year from the initial sale date. It is not clear how to account for this type of transaction under the proposed amendments.

24. The guidance was proposed only to clarify if multiple arrangements are really part of one overall plan, then they should be accounted for as a single arrangement. The staff believes that no matter what examples or how many examples we provide, we could never address every possible structuring transaction and that providing some guidance will result in even more requests for guidance. The staff also believes that by including the guidance on multiple arrangements in the NCI standards, the incentive to structure around the requirements would be reduced thus resulting in less need for any guidance.

25. The staff believes that the Boards should not incorporate detailed guidance on multiple arrangements in the NCI standard. The staff believes that, like every anti-abuse guidance, no matter what additional guidance we provide, it might not capture all transactions or events that are intended to be in its scope and might only result in more sophisticated structuring efforts in practice.

Staff recommendation and Question to the Boards

26. The staff recommends that for conceptual and practical reasons the Boards should provide guidance on multiple arrangements that are to be accounted for as a single arrangement which is based on principles-based indicators. The staff believes that the NCI standards should neither contain a necessarily incomplete list of illustrative examples nor additional application guidance on how to account for multiple transactions which are deemed to be a single transaction or arrangement. The staff proposes that the multiple arrangement guidance be redrafted as follows:

> A parent may lose c~~C~~ontrol of a subsidiary ~~may be lost~~ in two or more ~~transactions or~~ arrangements (transactions). In some cases, ~~An entity shall account for each such transaction or arrangement separately unless~~ circumstances indicate that the ~~transactions or~~ multiple arrangements are part of a single ~~transaction or~~ arrangement. In determining whether to account for the ~~transactions or~~ arrangements as a single ~~transaction or~~ arrangement, an entity shall consider all of the terms and conditions of the ~~transactions and~~ arrangements and their economic effects. ~~If o~~One or more of the following indicators ~~are present, the transactions or~~ may indicate that the multiple arrangements ~~are to~~ shall be accounted for as a single ~~transaction or~~ arrangement:

(a) they are entered into at the same time ~~or as part of a continuous sequence and in contemplation of one another~~.

(b) they are entered into in contemplation of one another

(c) they form a single arrangement ~~that achieves, or is~~ designed to achieve~~,~~ an overall commercial effect.

(d) the occurrence of one ~~transaction or~~ arrangement is dependent on the occurrence of at least one ~~the~~ other ~~transaction(s) or~~ arrangement~~(s)~~.

(e) one ~~or more of the~~ ~~transactions or~~ arrangement~~s~~ considered on ~~their~~ its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

~~The transactions or arrangements are to be accounted for separately if the entity can demonstrate clearly that they are not parts of a single transaction.~~

Do the Boards agree?