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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: **July 2007, London**

Project: **De-mergers and other in-specie distributions – Possible scope of the interpretative project (Agenda Paper 4)**

BACKGROUND

1. The issue raised in the submission concerns how an entity should account for de-mergers and other in-specie distributions in its financial statements. The submission focused on situations in which an entity distributes its ownership interest in a subsidiary to its shareholders and consequently loses control over that subsidiary.

2. At previous IFRIC meetings, the IFRIC commented that there had been *significant* diversity in practice in respect of how to account for de-mergers and other in-specie distributions in the financial statements of entities that distribute assets to their equity holders. At its May 2007 meeting, the IFRIC decided to take this issue onto its agenda in order to provide its constituents with guidance.

3. At its May 2007 meeting, the IFRIC also commented that it was crucial to ensure that the project's scope was sufficiently narrow to be capable of interpretation. Consequently, the IFRIC asked the staff to prepare a paper considering the possible scope of this interpretative project.

OVERVIEW OF PAPERS

4. This set of papers consists of:

- Paper 4, considering possible scope of this project; and
- Paper 4A, discussing possible alternative treatments of the transactions within the proposed scope of this project.

5. Paper 4 asks whether the IFRIC agrees with the scope suggested.

6. Paper 4A asks the IFRIC a number of questions, particularly regarding

- whether assets distributed by an entity to its equity holders should be remeasured at the time of distribution;
- at what amounts the assets should be remeasured; and
- how any difference between the carrying amounts and the remeasured amounts should be accounted for.

7. For the purposes of these papers, the time of distribution is when an entity declares distributions to its equity holders. Paragraph 13 of IAS 10 *Events after the Balance Sheet Date* states that dividends are declared when they are appropriately authorised and no longer at the discretion of the entity.

POSSIBLE SCOPE OF THIS PROJECT

8. To enable the IFRIC to reach consensus on the issues on a timely basis, the scope of the project must be sufficiently narrow.

9. This paper discusses the scope in the context of the following two aspects:

- transactions to be addressed in this project; and

- issues arising from those transactions within the proposed scope of this project.

Transactions to be addressed in this project

Should this project address <u>all</u> transactions between an entity and its equity holders?

10. Obviously, de-mergers and other in-specie distributions by an entity to its equity holders are examples of transactions between an entity and its equity holders.

11. The staff believes that transactions between an entity and its equity holders can generally be categorised into the following three types:

    - Exchange transactions between an entity and its equity holders;
    - Non-reciprocal transfers of assets by equity holders of an entity to the entity; and
    - Non-reciprocal transfers of assets by an entity to its equity holders.

12. Exchange transactions are different from non-reciprocal transfers in a number of respects:

    - ***Whether the entity receives anything* –** In an exchange transaction, both the entity and its equity holders will receive something in return, regardless of whether the exchange is at fair value. However, in a non-reciprocal transfer of assets by an entity to its equity holders, the entity will receive nothing.
    - ***Role of equity holders in the transactions* –** In an exchange transaction, the equity holders might *not* act in their capacity as equity holders. Indeed, they might act in their capacity as third party traders, especially when they enter into sales and/or purchases with the entity at fair value. However, in a non-reciprocal transfer, the equity holders act in their capacity as equity holders. Otherwise, it is difficult to explain why the entity would give up something to its equity holders for nothing.

13. The staff recommends the IFRIC *not* to address exchange transactions in this project.

14. Dealing with exchange transactions would probably result in this project addressing all related party transactions. The staff considers such a scope *too broad* for interpretation purposes.

15. In addition, the staff recommends the IFRIC not to address non-reciprocal transfers of assets *by equity holders of an entity to the entity* for the following reasons:

- De-mergers and other in-specie distributions are non-reciprocal transfers of assets by an entity to its equity holders.
- There is some guidance in IFRSs on how to account for transfers of assets by equity holders of an entity to the entity. For example, when an entity receives services from its employees and the parent of the entity (not the entity) has the obligation to provide the employees with the equity instruments of the parent, IFRS 2 *Share-based Payment* and IFRIC 11 *IFRS 2 – Group and Treasury Share Transactions* require the entity to recognise services from its employees at fair value, with the corresponding increase recognised in equity as a contribution from the parent.

16. Therefore, the staff recommends that:

- This project should focus on non-reciprocal transfers of assets by an entity to its equity holders; and
- This project should define in-specie distributions in the context of *unconditional non-reciprocal transfers* of assets by an entity to its equity holders *acting in their capacity as equity holders*. After the transfers, the entity is no longer entitled to any future economic benefits derived from the *assets distributed*. Paragraph 20 of this paper discusses the types of assets this project might focus on. Both de-mergers and other in-specie distributions are essentially distributions in kind. Therefore, for the purposes of these papers, de-mergers and other in-specie distributions are all considered as in-specie distributions.

17. In the staff's view, such a limited scope would help the IFRIC concentrate on the issues set out in paragraph 6 of this paper.

18. Moreover, this paper suggests that this project should deal with situations in which all equity holders of an entity within the same class[1] are treated *equally*. For example, the amounts of distributions are determined based on equity holders' respective proportional ownership interests in the entity concerned.

19. This paper recommends that the IFRIC should *not* address situations in which equity holders of an entity within the same class are *not* treated equally. This is because:

- such transactions might imply that some equity holders might indeed give up something to the entity and/or other equity holders. In other words, such transactions might be more in the nature of exchange transactions; and
- such transactions might involve corporate governance issues.

What kind of assets distributed should this project focus on?

20. This paper recommends that the IFRIC should *not* address the accounting for cash distributions. The carrying amount of cash is the same as its fair value. Issues associated with non-cash distributions, as set out in paragraph 6 of this paper, are *not* applicable to cash distributions.

21. Instead, this project should focus on distributions of assets other than cash to equity holders in their capacity as equity holders.

22. The transactions addressed in this project are essentially distributions in kind. In the staff's view, the measurement of distributions should be the same regardless of the type of assets distributed. Consequently, the staff recommends that the IFRIC should *not* restrict the project by limiting the assets distributed to ownership interests in subsidiaries. Assets distributed in the scope of this project could be any non-cash assets.

[1] All equity holders of an entity within the same class have the same rights, e.g. distribution, voting etc..

23. For subsequent discussion, the staff categorises the assets distributed based on the measurement attribute of the assets immediately before the distribution:

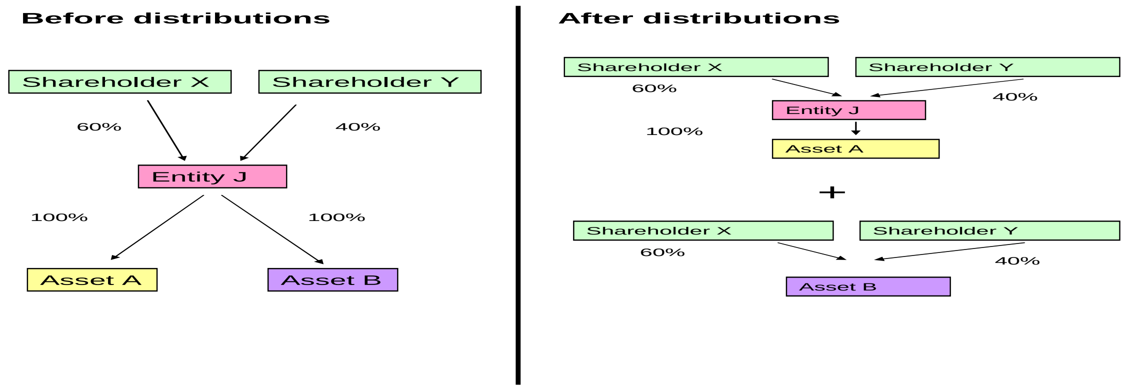
- Assets measured at fair value through profit or loss (for example, financial assets at fair value through profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement,* investment properties accounted for under the fair value model in accordance with IAS 40 *Investment Property*);
- Assets measured at fair value through equity (for example, land and buildings under the revaluation model in IAS 16 *Property, Plant and Equipment*, available-for-sale financial assets in accordance with IAS 39);
- Assets measured at cost or amortised cost (for example, property, plant and equipment in accordance with IAS 16, leasehold land in accordance with IAS 17 *Leases*, loans and receivables in accordance with IAS 39);
- Assets not previously recognised (for example, internally generated assets that do not qualify for recognition under IAS 38 *Intangible Assets*); and
- Ownership interests in subsidiaries, associates and joint ventures.

In summary…

24. The following is a summary of the possible features of transactions to be addressed in this project:

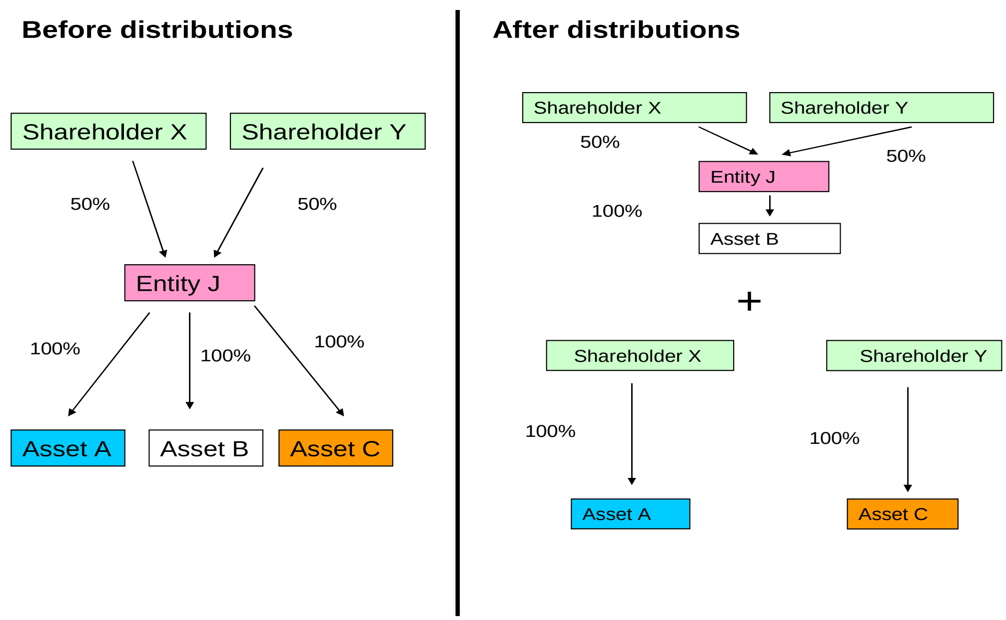
- Define in-specie distributions as unconditional non-reciprocal transfers of assets by an entity to its equity holders acting in their capacity as equity holders.
- All equity holders of an entity within the same class are treated equally.
- After the distribution, the entity that distributes the assets is no longer entitled to any future economic benefits derived from the *assets distributed*.
- Assets distributed can be any non-cash assets (including ownership interests in subsidiaries, associates and joint ventures).
- Focus on the financial statements of the entity that distributes the assets.

25. The diagrams below illustrate two examples that are within the suggested scope. Example 1 is as follows:



26. In Example 1, Entity J distributes Asset B to Shareholders X and Y based on their respective ownership interests in Entity J.

27. Example 2 is as follows:



28. In Example 2, Entity J distributes Asset A and Asset C to Shareholder X and Shareholder Y respectively. The fair values of Asset A and Asset C at the time of distribution must be the same if Shareholder X and Shareholder Y are treated

equally. However, the carrying amounts of Asset A and Asset C immediately before the distribution might *not* be the same.

Questions for the IFRIC

29. Does the IFRIC agree with the possible features of the transactions within the scope of this project (see paragraph 24 of this paper)?

30. If not, what else does the IFRIC wish to address? And why?

Issues arising from transactions within the proposed scope

31. Based on the above suggested scope, the following possible issues arise:

- Whether the assets distributed should be remeasured at the time of distribution, particularly what triggers remeasurement;
- If so, to what amounts, the assets should be remeasured; and
- How any differences between the carrying amounts and the remeasured amounts should be accounted for.

32. Additional questions may arise when the assets distributed are ownership interests in subsidiaries, associates and joint ventures. Those questions might include:

- Should the ownership interests that continue to be held by the entity be remeasured? In all circumstances or only in certain circumstances?
- If so, how should any differences between the carrying amounts and the remeasured amounts be accounted for?

33. The staff recommends that the IFRIC should *first* focus on issues raised in paragraph 31 of this paper. After the IFRIC reaches consensus on those issues, the IFRIC might consider other questions set out in paragraph 32 of this paper.

Questions for the IFRIC

34. Does the IFRIC agree that this project should focus on the issues raised in paragraph 31 of this paper?

35. Are there any other issues the IFRIC wishes to address?