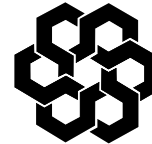

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International Accounting Standards Board

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 alternative treatments (Agenda Paper 4A)**

BACKGROUND

1. Paper 4 suggests restricting the scope of this interpretative project by defining in-specie distributions as unconditional non-reciprocal transfers of assets by an entity to its equity holders in their capacity as equity holders.

2. In addition, Paper 4 recommends that this project should focus on the financial statements of the entity that distributes its assets to its equity holders.

3. Based on the proposed scope, Paper 4 recommends that this project should address the following issues:

   - 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 difference between the carrying amounts and the remeasured amounts should be accounted for.

4. Current IFRSs do not address the above issues. Indeed, current IFRSs only require that distributions to equity holders should be presented in equity directly (not through profit or loss) and that the amounts of distributions should be separately disclosed in the financial statements (see paragraph 35 of IAS 32 Financial Instruments: Presentation and paragraph 97(a) of IAS 1 Presentation of Financial Statements).

TWO COMMON ALTERNATIVES IDENTIFIED IN PRACTICE

5. Regarding whether the assets distributed should be remeasured at the time of distribution, there are two possible alternative treatments:

- ***Alternative 1*** – An entity should *not* remeasure the assets distributed. Distributions to equity holders are debited directly to equity based on the carrying amounts of the assets immediately before distribution.
- ***Alternative 2*** – An entity should remeasure the assets to their fair values at the time of distribution. Any differences between the carrying amounts and fair values should be recognised in profit or loss immediately.

6. Regarding Alternative 2, this paper will later discuss the appropriate measurement basis for the assets distributed at the time of distribution and how any difference between the carrying amounts and the remeasured amounts of the assets distributed should be accounted for (see paragraph 59 and paragraph 67 respectively).

OVERVIEW OF THIS PAPER

7. This paper consists of two parts:

- Part A – How to assess different alternative treatments (given that current IFRSs do *not* specifically address the issues); and
- Part B – Assessment of different alternative treatments of the transactions within the proposed scope of this project.

8. This paper asks the IFRIC which alternative treatment it prefers and requests comments on the issues raised in this paper.

PART A - HOW TO ASSESS EACH POSSIBLE ALTERNATIVE?

9. Paragraph 10 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* deals with establishing accounting policies in the absence of a Standard or an Interpretation. Paragraph 10 of IAS 8 requires an entity to use its judgement in developing and applying an accounting policy that results in providing users of financial statements with relevant and reliable information.

10. In making this judgement, paragraph 11 of IAS 8 requires an entity to consider any Standards or Interpretations that can be applied by analogy. If those Standards or Interpretations do not exist, paragraph 11 of IAS 8 requires the entity to refer to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework for the Preparation and Presentation of Financial Statements* (the Framework).

11. Paragraph 12 of the Framework states: 'The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.'

12. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users of financial statements. The four principal qualitative characteristics set out in the Framework are understandability, relevance, reliability and comparability.

13. Therefore, in assessing each possible accounting treatment, this paper considers those four principal qualitative characteristics set out in the Framework.

Relevant guidance in US

14. Paragraph 12 of IAS 8 states: 'In making the judgement described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting

standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11.'

15. The staff notes that US APB Opinion No. 29 *Accounting for Nonmonetary Transactions*, which *was issued in 1973*, specifies that distributions of non-monetary assets by an entity to its shareholders on a pro rata basis (e.g. in a demerger) should be based on the carrying amounts of the non-monetary assets distributed.

16. This paper does *not* discuss in detail the requirements in US APB Opinion No. 29. Instead, this paper sets out the conceptual debate of each possible alternative as the staff believes that it is essential to consider such conceptual arguments for and against each alternative.

FROM WHOSE PERSPECTIVE, SHOULD THE EFFECT OF A TRANSACTION BE CONSIDERED?

17. Before assessing each alternative, it is crucial to consider a question – that is, from whose perspective, the effect of a transaction should be considered.

18. Paper 4 suggests focusing on the financial statements of the entity that distributes its assets to its equity holders.

19. The Framework states that the objective of financial statements is to report information about the financial position, performance and changes in financial position *of an entity* (see paragraph 12 of the Framework). Such an objective requires the effect of the transaction to be considered from the perspective of the entity for which the financial statements are prepared.

20. Some argue that the effect of a transaction could be considered from the perspective of the equity holders of the entity. They note that some entities in practice account for 'business combinations involving entities under common control' with 'merger accounting'. One argument for 'merger accounting' is that interests of equity holders of combining entities, before and after business combinations, remain the same.

21. The fact that some entities use ‘merger accounting’ to account for ‘business combinations involving entities under common control’ does *not* mean that IFRSs require entities to consider the effect of ‘business combinations involving entities under common control’ from the perspective of equity holders of combining entities.

22. The reason ‘merger accounting’ is used in practice is that ‘business combinations involving entities under common control’ are outside the scope of IFRS 3 *Business Combinations*[1].

23. [Paragraph omitted from observer note.]

24. Moreover, it is important to note that *general purpose financial statements* are prepared for a wide range of users (*not* just equity holders) (see paragraph 12 of the Framework). Therefore, it does not seem appropriate to consider the effect of a transaction from the perspective of equity holders *only*.

25. For the above reasons, the staff believes that the effect of a transaction should be considered from the perspective of the entity for which the financial statements are prepared (*not* just from the perspective of equity holders). Any deviation from this principle must be justified.

26. Consequently, regarding Examples 1 and 2 set out in paragraphs 25-28 of Paper 4, the staff recommends that the effect of the transactions should be considered from the perspective of Entity J.

[1] For information: The Board has not yet decided whether to take ‘business combinations involving entities under common control’ onto its agenda.

Questions for the IFRIC

27. Does the IFRIC agree that the effect of a transaction should be considered from the perspective of the entity for which the financial statements are prepared?

28. If not, why not? And how would the IFRIC justify this apparent exception to the Framework?

PART B – ASSESSMENT OF DIFFERENT ALTERNATIVE TREATMENTS

29. As mentioned above, the two alternatives are:

- ***Alternative 1*** – An entity should *not* remeasure the assets distributed at the time of distribution; and
- ***Alternative 2*** – An entity should remeasure the assets distributed at the time of distribution.

Alternative 1 – No remeasurement of the assets distributed at the time of distribution

Arguments for Alternative 1 - Equity holders' interests in assets distributed might remain the same before and after the distributions

30. One argument is that, before and after the distribution, the equity holders still enjoy the same interests in the assets distributed (see Example 1 in paragraph 25 of Paper 4). In Example 1, Shareholders X and Y still enjoy the same interests before and after distribution.

31. However, some note that such an argument considers the effect of the transactions from the perspective of the equity holders. As mentioned above, the effect of a transaction should be considered from the perspective of the entity for which the financial statements are prepared.

32. In addition, in some circumstances, equity holders' ownership interests in assets before and after the distribution might be different (see Example 2 in paragraph 27

of Paper 4). In Example 2, Shareholder X and Shareholder Y lose their interests in Asset C and Asset A respectively.

33. Both Example 1 and Example 2 have the same nature – that is, Entity J in both Examples 1 and 2 distributes ‘something’ valuable to its equity holders. In the staff’s view, the accounting treatments for Example 1 and Example 2 (particularly, the measurement) should be the same.

Arguments for Alternative 1 – Consistency with the definitions of ‘income’ and ‘expense’ in the Framework

34. Supporters of Alternative 1 note the following two definitions in the Framework:

- *Income* is defined as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, *other than those relating to contributions from equity participants* (see paragraph 70(a) of the Framework).
- *Expenses* are defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or occurrences of liabilities that result in decreases in equity, *other than those relating to distributions to equity participants* (see paragraph 70(b) of the Framework).

35. Based on the above two definitions, proponents of Alternative 1 argue that distribution should *not* result in any gains or losses being recognised in profit or loss. Consequently, they believe that the assets distributed should *not* be remeasured at the time of distribution.

36. Instead, supporters of Alternative 1 recommend that the entity that distributes the assets should disclose information in accordance with IAS 24 *Related Party Disclosures*. Paragraph 17 of IAS 24 requires an entity to disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. Proponents of Alternative 1 believe that IAS 24 requires the entity to disclose the fair values of the assets distributed (though some might argue that paragraph 17 of IAS 24 does *not* specifically require such information to be disclosed).

37. However, it is important to note that the definitions of income and expenses in the Framework do *not* address whether assets distributed should be remeasured at the time of distribution. Indeed, the definitions of income and expenses *merely* require distribution to equity holders and contribution from equity holders to be *presented* directly in equity (rather than in profit or loss). Arguably, Alternative 2 would also meet this presentation requirement (see the discussion in ***Issue 5*** below).

38. In addition, as mentioned in ***Issue 4*** below, any difference between the carrying amounts and the remeasured amounts of the assets distributed at the time of distribution could represent cumulative unrecognised increases or decreases in economic benefits of the assets distributed. The difference that reflects performance of the entity should be recognised by the entity before the assets are distributed.

39. This paper will later discuss what triggers remeasurement (see the discussion in ***Issue 1*** below).

Arguments against Alternative 1 – Does not meet the 'comparability' qualitative characteristic

40. Alternative 1 results in distributions being recorded on different measurement bases, even though assets are being used for the same purpose (that is – for distributing 'something' valuable to equity holders). In other words, Alternative 1 does *not* meet the 'comparability' characteristic set out in the Framework. This is illustrated in the table below.

Types of assets distributed	**Measurement bases for distributions**
1) Assets measured at fair value through profit or loss (e.g. financial assets at fair value through profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* and investment properties under the fair value model in accordance with IAS 40 *Investment Property*).	Distributions are recorded at fair value.
2) Assets measured at fair value through equity (e.g. available-for-sale financial assets in accordance with IAS 39).	Distributions are recorded at fair value. For available-for-sale financial assets, the cumulative gain or loss that has been recognised directly in equity *will be recycled to profit or loss* when the assets are derecognised (see paragraph 26 of IAS 39). Hence, there might be an effect on profit or loss. Under IAS 39, an entity should derecognise an asset when it is no longer entitled to the contractual rights to the cash flows from the asset, regardless of whether the assets are transferred to the equity holders of the entity or third parties. For other non-financial assets (e.g. intangible assets and property, plant and equipment), the cumulative gain or loss that has been recognised directly in equity will be recycled *within equity* to retained earnings when the assets are derecognised (see paragraph 41 of IAS 16 *Property, Plant and Equipment* and paragraph 87 of IAS 38 *Intangible Assets*).

Types of assets distributed	**Measurement bases for distributions**
3) Assets measured at cost or amortised cost (e.g. property, plant and equipment in accordance with IAS 16, leasehold land in accordance with IAS 17 *Leases* and loans and receivables carried at amortised cost less impairment in accordance with IAS 39).	Distributions are recorded at cost or amortised cost, less any previously recognised impairment. No gain or loss is recognised in profit or loss. It is important to note that the recoverable amount of an asset in accordance with IAS 36 *Impairment of Assets* is the higher of the asset's fair value less costs to sell and its value in use. Consequently, distributions might be recorded on the basis of 'value in use' – that basis, in the staff's view, does *not* reflect the fact that the assets are distributed to equity holders.
4) Assets that have not been recognised in the balance sheet (e.g. internally generated intangible assets that do not qualify for recognition in accordance with IAS 38).	Distributions are recorded at nil amounts or are not recognised at all.
5) Ownership interests in subsidiaries, associates or joint ventures.	Distributions are recorded based on the proportion of the ownership interests distributed. The carrying amounts of ownership interests in subsidiaries, associates or joint ventures are determined in accordance with IAS 27, IAS 28 or IAS 31 respectively. It is important to note that, under Alternative 1, the amounts of the distribution are likely to differ between the separate financial statements of the parent and the consolidated financial statements of the parent. In the separate financial statements of the parent, investments in subsidiaries, jointly controlled entities and associates that are not classified as held for sale in accordance with IFRS 5 are required to be measured either at cost or in accordance with IAS 39. However, in the consolidated financial statements of the parent, the 'carrying amounts' of interests in subsidiaries, jointly controlled entities and associates are recorded based on the proportion of 'cost plus post-acquisition reserves' (essentially, the amount resulting from applying the equity method).

41. In addition, when different types of assets with the same fair values but different carrying amounts are distributed to equity holders (see Example 2 in paragraph 27 of Paper 4), Alternative 1 might *not* faithfully reflect in the financial statements that all equity holders of an entity within the same class are treated equally.

42. As mentioned above, proponents of Alternative 1 argue that distributions should not result in any gains or losses being recognised in profit or loss. However, this is *not* always the case under Alternative 1. Under Alternative 1, some distributions (e.g. those involving assets measured at fair value through equity) might have profit or loss effect.

Arguments against Alternative 1 – Does not meet the 'understandability' and 'relevance' qualitative characteristics

43. If distributions are recorded at the carrying amounts of the assets immediately before the distributions, users of the financial statements are unable to assess the 'true' value of assets given up at the time of distribution.

44. As pointed out earlier, supporters of Alternative 1 might argue that such a consequence could be remedied by disclosing the fair values of the assets distributed in the financial statements.

45. The staff is *not* persuaded by such a remedy. Otherwise, all assets could be recorded at historical costs supplemented by fair value disclosures. In order to faithfully represent the fact that an entity has distributed 'something' valuable to its equity holders, distributions should be measured based on the value of the assets distributed at the time of distribution. IAS 1 *Presentation of Financial Statements* and IAS 24 deal with presentation and disclosure issues only. They do not address recognition and measurement issues.

Alternative 2 – Assets distributed should be remeasured at the time of distribution

Arguments for Alternative 2

46. There are a number of arguments for Alternative 2 in the context of understandability, relevance and comparability:

    - Regardless of the types of assets distributed, the *same* measurement basis is used under Alternative 2. Hence, *comparability* can be enhanced. The transactions addressed in this project have the same nature – that is, they are distributions in kind.
    - An entity distributes 'something' valuable to its equity holders. Alternative 2 *faithfully* reflects the value of distributions at the time of distribution in the financial statements of the entity that distributes the assets.

47. In addition, proponents of Alternative 2 believe that the nature of the transactions addressed in this project could be viewed as being, in substance, two transactions – one transaction in which an entity sells its non-cash assets in a market for cash; and another in which the entity distributes the cash received to its equity holders.

48. Under the two-transaction approach, a gain or loss on derecognition of the assets is recognised in profit or loss immediately.

49. Therefore, another argument for Alternative 2 is that it achieves the results that are closer to those that would be achieved if the entity instead entered into the two transactions.

50. Some might argue that the transactions addressed in this project are different from the two transactions because the former do not involve any disposals. However, proponents of Alternative 2 would argue that the two transactions have the same substance but different forms.

51. In addition, proponents of Alternative 2 note that IAS 16 and IAS 38 generally require exchanges of non-monetary assets to be recorded at fair values, even when there are no sale proceeds involved.

52. Similarly, SFAS No. 153 *Exchanges of Non-monetary Assets* generally requires exchanges of non-monetary assets to be recorded at fair values. The original requirements in US APB Opinion No. 29 that required exchanges of non-monetary assets to be recorded at carrying amounts were superseded by SFAS No. 153.

Issues to be addressed under Alternative 2

53. Obviously, there are a number of issues associated with Alternative 2. They are as follows:

- ***Issue 1*** – Alternative 2 requires remeasurement of assets distributed at the time of distribution. A question arises as to *what triggers remeasurement*.
- ***Issue 2*** – *To what amounts*, should the assets be remeasured? Should the assets be remeasured to their fair values?
- ***Issue 3*** – Can the new measurement basis be determined *reliably*? Should there be any *exceptions* to remeasurement (when there is clear evidence that the new measurement basis cannot be measured reliably)?
- ***Issue 4*** – How should any difference between the carrying amounts and the remeasured amounts be accounted for?
- ***Issue 5*** – Does the remeasurement requirement contradict any IFRSs that are applicable to assets before they are distributed (especially, IAS 38)?

Issue 1 - What triggers remeasurement?

54. From the perspective of the entity that distributes the assets, clearly there is a change in how the assets concerned are realised. The future economic benefits of the assets distributed will no longer be realised through use - evidenced by distributions of the assets. In addition, after the distribution, the entity is no longer entitled to any future economic benefits derived from the *assets distributed*.

55. In addition, supporters of Alternative 2 note that, when there is a change in use of an asset, several IFRSs require remeasurement of the asset (the question regarding what the new measurement basis should be is addressed in ***Issue 2***). Those relevant IFRS requirements include:

   - IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires entities to *remeasure* assets (or disposal groups) when those assets (or disposal groups) are classified as held for sale (i.e. when management is committed to recover the carrying amounts of those assets principally through sale rather through continuing use); and
   - IAS 40 provides specific guidance on what the new measurement for a property is when there is a transfer from/to investment properties.

56. In the light of these IFRS requirements, supporters of Alternative 2 believe that assets distributed should be remeasured at the time of distribution to reflect a change in how the future economic benefits of the assets are realised.

57. Moreover, supporters of Alternative 2 believe that the remeasurement requirement is consistent with the reasons why IFRSs have different measurement bases for assets that are used in different ways.

58. Furthermore, supporters of Alternative 2 believe that the loss of future economic benefits of the *assets distributed* is a significant economic event that should trigger remeasurement.

Issue 2 – To what amounts should the assets be remeasured? Should the assets be remeasured to their fair values?

59. Some suggest that assets should be remeasured to their fair values[2] at the time of distribution. As mentioned earlier, some believe that the nature of the transactions addressed in this paper is similar to the nature of the two-transaction approach set out in paragraph 47. In their view, the use of fair values best reflects the nature of the transactions addressed in this project.

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[2] Fair value under IFRSs is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

60. Alternatively, some argue that the new measurement base could be determined by reference to the requirements in IFRS 5. IFRS 5 requires assets (or disposal groups) classified as held for sale to be remeasured to the lower of their carrying amounts and fair value less costs to sell.

61. However, proponents of Alternative 2 believe that the measurement basis in IFRS 5 is merely to ensure adequate impairment losses are made since the assets are classified as held for sale. If the amount of the fair value less costs to sell is higher than the carrying amount, the difference is recognised when the sale occurs.

62. It is important to note that the entity that distributes the assets loses the future economic benefits to be derived from those *assets distributed*. This consequence is similar to consequences of other types of asset realisations (e.g. disposals). Consequently, supporters of Alternative 2 believe that the new measurement basis should consider *both the downside and upside effects* (i.e. *not merely* consider the adequacy of impairment losses).

Issue 3 - Can fair values be determined reliably? If not, should any exceptions to fair value measurement be given?

63. Generally, there should *not* be significant difficulties associated with the determination of fair values of tangible assets (e.g. property, plant and equipment, investment properties, inventories).

64. However, some note that there might be some difficulties associated with the determination of fair values of (i) intangible assets and (2) equity investments that are *not* traded in active markets. Consequently, they suggest that exceptions to fair value measurement should be given (when there is clear evidence that fair values cannot be determined reliably).

65. The table below summaries different arguments as to whether any exceptions to fair value measurement should be given.

Arguments *for* 'exceptions to the fair value measurement'
• Certain IFRSs do not allow items whose fair value cannot be determined reliably to be measured at fair value (see paragraph 9 of IAS 39). Hence, some argue that, when there is clear evidence that fair values cannot be determined reliably, distributions should be recorded at carrying amounts of the assets distributed. • However, paragraph 30 of *IFRS 7 Financial Instruments: Disclosures* requires an entity to disclose the following information when the entity records certain financial instruments at cost in accordance with paragraph 9 of IAS 39: o an explanation of why fair value cannot be measured reliably; and o at the time of derecognition, the carrying amounts of the assets derecognised and the amount of gain or loss recognised.
Arguments *against* 'exceptions to the fair value measurement'
• Management (and equity holders) of an entity should know the fair values of the assets distributed. The management of an entity has the fiduciary duty to ensure that all equity holders of the entity within the same class are treated equally. • In Example 2 (as set out in paragraph 27 of Paper 4), equity holders who have the same ownership interests in Entity J are distributed assets with the same fair values but different carrying amounts. Obviously, management of Entity J should know the fair value of the assets distributed at the time of the distribution to exercise its fiduciary duty to treat shareholders of the same class equally. • [Paragraph omitted from observer note.]

66. Supporters of Alternative 2 believe that exceptions to fair value measurement should *not* be given. They believe that management (and equity holders) should know the fair values of the assets distributed.

Issue 4 – How should any difference between the carrying amounts and fair values of the assets distributed be accounted for?

a) What does the difference represent?

67. Before determining the accounting treatment, it is crucial to find out what the difference between the carrying amounts and fair values of the assets distributed represents.

68. The difference represents *cumulative unrecognised increases or decreases in economic benefits of the assets distributed*. Until an entity distributes its assets to its equity holders, the difference that reflects the performance of the entity *belongs to the entity*. Supporters of Alternative 2 believe that such increases or decreases in economic benefits should be recognised before they are distributed.

69. If the assets were *not* remeasured to fair values, those cumulative increases or decreases in economic benefits of the assets that reflect the performance of the entity would *never* be recognised in the financial statements of the entity.

b) Where should the difference go?

70. Proponents of Alternative 2 believe that the difference should be recognised in profit or loss, regardless of the type of assets distributed. They note that, on realisation of a non-cash asset (e.g. by sale or by donation), IFRSs require the difference between the sales proceeds and carrying amount of the asset to be recognised in profit or loss.

71. Supporters of Alternative 2 argue that, if the difference between the carrying amounts and fair values of the assets distributed were *not* recognised in profit or loss, there might be an exception to the normal accounting for gains or losses on realisation of an asset.

c) Does the recognition of the difference in profit or loss contradict the definitions of income and expenses in the Framework?

72. Under the Framework, income is defined as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. Similarly, expenses are defined as decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

73. The above two definitions require two things:

    - There must be increases or decreases in economic benefits to meet the definitions of income and expenses; and
    - Distributions to equity participants or contributions from equity participants should *not* be presented as expenses or income in profit or loss.

74. As mentioned above, any difference between the carrying amounts and fair values of the assets distributed at the time of distribution represent *unrecognised increases or decreases in economic benefits of the assets*. Consequently, such increases or decreases in economic benefits are not the *result* of the distribution to equity holders. Instead, they have arisen since the assets were acquired but have *not* been recognised yet.

75. Moreover, the two journal entries of Alternative 2 are as follows (assuming that the fair value (FV) is greater than the carrying amount (CA)):

Journal entry 1:

DR	Assets	FV – CA	
CR	Profit or loss		FV – CA

To remeasure the assets distributed at fair values.

Journal entry 2:

DR	Distributions (directly in equity)	FV	
CR	Assets		FV

To record the distributions to equity holders.

76. Consistent with the definition of expenses set out in the Framework, distributions are presented directly in equity (*not* profit or loss) (see Journal entry 2 above).

Issue 5 – Does the remeasurement requirement contradict any IFRSs applicable to assets before they are distributed (especially, IAS 38)?

77. Under IAS 38, the carrying amounts of internally generated intangible assets are generally restricted to the sum of expenditure incurred by an entity. Consequently, some are concerned that the remeasurement requirement might contradict the relevant requirements in IAS 38.

78. Possible reasons for such requirements in IAS 38 include:

- Certain internally generated intangible assets might *not* be identifiable.
- Fair values of those assets might *not* be able to be determined reliably.
- It is difficult to demonstrate that it is probable that future economic benefits embodied in those assets will flow to the entity (the probability criterion).

79. Regarding the first point, the entity must be able to identify the assets at the time of distribution.

80. The second point has been discussed in ***Issue 3***. As mentioned above, management (and equity holders) of the entity should know the fair values of the assets distributed at the time of distribution.

81. Regarding the third point, supporters of Alternative 2 believe that the probability criterion would be met at the time of distribution because:

    - In their view, intangible assets are often distributed together with other assets (e.g. in the form of a business). When an entity determines the fair value of the business distributed, it takes into account the fair values of the intangible assets. The fair values of the intangible assets reflect market expectations of the probability that the future economic benefits embodied in the intangible assets will flow to an entity. Hence, the probability criterion is always considered to be satisfied. The Board accepted a similar argument when it discussed the probability criterion for recognising intangible assets acquired in a business combination (see paragraph 33 of IAS 38). Such arguments could be applied to disposals of a business through sale, donation or distribution.
    - Paragraph 55 of the Framework states that future economic benefits embodied in an asset may flow to an entity by being distributed to the equity holders of the entity. Hence, at the time of distribution, the future economic benefits can be demonstrated.

82. For the above reasons, supporters of Alternative 2 do *not* believe that the remeasurement requirement contradicts IAS 38.

SUMMARY OF THE TWO ALTERATIVES

83. A summary of Alternative 1 is set out below.

Features of Alternative 1:
• Distributions are recorded at the carrying amounts of the assets distributed immediately prior to the distribution. • No gain or loss is recognised in profit or loss. • Instead, the fair values of the assets distributed are disclosed in the notes to the financial statements.
Arguments *for* Alternative 1:
• Equity holders' interest, before and after distributions, remain the same (though as noted in paragraph 32, this is *not* always the case). • Distributions of non-cash assets by an entity to its equity holders are transactions between an entity and its equity holders. Hence, no gain or loss should be recognised in profit or loss. However, as mentioned above, the definitions of income and expenses in the Framework do *not* address whether the assets distributed should be remeasured at the time of distribution.
Arguments *against* Alternative 1:
• Alternative 1 does *not* meet the 'relevance' and 'comparability' characteristics. Distributions are recorded on different bases (depending on the carrying amounts of the assets immediately before distributions).

84. A summary of Alternative 2 is set out below.

Features of Alternative 2:
• Assets are remeasured to their fair values at the time of distribution. • Any difference between the carrying amounts and fair values is recognised in profit or loss immediately. • No exception to the fair value measurement requirement is given.
Arguments *for* Alternative 2:
• Alternative 2 meets most of the qualitative characteristics set out in the Framework (e.g. understandability, relevance and comparability). • The assets concerned are realised at the time of distribution. Such a change triggers remeasurement. • Management (and equity holders) of the entity should know the fair values of the assets distributed at the time of distribution. • Any differences between the carrying amounts and fair values of the assets distributed represent cumulative unrecognised increases or decreases in economic benefits of the assets distributed. Such differences reflect the performance of the entity up to the time of distribution and belong to the entity until those assets are distributed. Hence, they should be recognised at the time of distribution.

85. Both Alternative 1 and Alternative 2 require the determination of fair values of the assets distributed. As mentioned above, Alternative 1 requires the disclosure of fair values of the assets distributed at the time of distribution. Therefore, Alternative 2 does *not* add further complexity in terms of the determination of fair values (*unless the IFRIC does not require the disclosure of fair values under Alternative 1*).

STAFF RECOMMENDATION

86. The staff recommends Alternative 2.

87. Some might argue that fair values of the assets distributed cannot be determined reliably. However, the staff believes that management (and equity holders) should know the fair values of the assets distributed.

QUESTIONS FOR THE IFRIC

88. Which alternative does the IFRIC prefer? And why?

89. If the IFRIC prefers Alternative 1 (i.e. distributions are recorded at carrying amounts of the assets immediately before distributions), the staff would like to ask:

    - What additional arguments does the IFRIC have in support of Alternative 1?
    - How would the IFRIC tackle the arguments against Alternative 1?
    - How would the IFRIC justify that like transactions might *not* be accounted for in the same way?
    - Why does the IFRIC believe that Alternative 2 is *not* an appropriate answer?
    - Would the IFRIC require fair values of the assets distributed to be disclosed in the financial statements of the entity that distributes the assets?

90. If the IFRIC prefers Alternative 2 (i.e. distributions are recorded at fair values of the assets distributed at the time of distribution), does the IFRIC have any comments on the five issues raised in paragraphs 53 – 82? In particular, the staff would like to know:

    - Should exceptions to the fair value measurement be given? If so, under what circumstances should exceptions be given?
    - Does the IFRIC agree that any differences between the carrying amounts and fair values of the assets distributed should be recognised in profit or loss? If not, why? And where should the difference go?