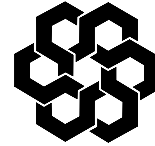

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International Accounting Standards Board

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: **March 2007, London**

Project: **Plan to sell the controlling interest in a subsidiary (Agenda Papers 3)**

Background

1. The IFRIC received a request (see appendix 1) to provide guidance on applying IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when an entity is committed to a plan to sell the controlling interest in a subsidiary. After the planned sale, the entity would retain a non-controlling interest in its subsidiary, taking the form of either an investment in an associate, an investment in a joint venture or a financial asset.

Issues

2. The submitter raised three issues for the preparation of consolidated financial statements:

   - Issue 1: whether the intention to sell a portion of the subsidiary triggers classification of the subsidiary's assets and liabilities as held for sale under IFRS 5.

- Issue 2: if classification as held for sale is appropriate, should all assets and liabilities of the subsidiary or only the portion to be sold, be classified as held for sale and measured accordingly?
- Issue 3: after the sale, how should the remaining non-controlling equity investment be measured, at carrying amount or at fair value?

3. A related question is, if the intention to sell a portion of a subsidiary is considered sufficient to result in classification as held for sale, then should the planned sale also result in classification of the subsidiary as a discontinued operation if it meets the specified criteria and, if there is presentation as a discontinued operation, then should the whole of the subsidiary or only the portion that is to be sold be presented as a discontinued operation.
4. The staff believe the issues above should be broken down as follows:
   a) Are criteria for classification as held for sale met?
   b) What should be classified as held for sale when criteria are met?
   c) During the held for sale period, how should the subsidiary's assets and liabilities be measured?
   d) Is classification as discontinued operations relevant when the entity plans to retain a significant influence over its former subsidiary after the sale?
   e) After the sale of the controlling interest, how should the remaining investment be measured?
   f) What information should be disclosed in the notes to the consolidated financial statements?

Staff analysis

a) Are criteria for classification as held for sale met?

5. When issuing IFRS 5 (see BC 17), the Board concluded that providing information about assets and groups of assets and liabilities to be disposed of is of benefit to users of financial statements. Such information should assist users in assessing the timing, amount and uncertainty of future cash flows.
6. IFRS 5 paragraph 2 (scope) states that the classification and presentation requirements of IFRS 5 apply to all non-current assets and to all disposal groups

of an entity and requires entities to classify them as held for sale when criteria set out in paragraphs 6 to 12 are met.

7. In particular, paragraph 6 of IFRS 5 states that "An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use". (emphasis added)

8. The staff is aware that this paragraph and the term "principally" are interpreted in two different ways:

    i. Having a plan involving loss of control over an asset or a group of assets is the triggering event for the classification as held for sale. A remaining non-controlling interest does not provide a "continuing use" of the asset or group of assets;

    ii. "principally through a sale" means that the majority of the interest in the subsidiary has to be disposed of to meet the criteria for classification as held for sale.

9. The staff believe that approach i) is the only one relying on principles set out in IFRSs. IAS 27 defines control and requires a parent to consolidate a controlled entity (a subsidiary) until control is lost. On disposal, the parent will get a different asset in exchange of the sale because **an investment in a subsidiary is economically different from a non-controlling equity investment**. The notion of control is crucial because what is to be sold is the controlling interest in exchange for a non-controlling interest, rather than merely a portion of assets and liabilities. Therefore, when the parent has a plan to sell the controlling interest of a subsidiary, even if disposal is only partial, classification as held for sale is relevant for the holding period before the disposal. This approach is also consistent with the Proposed FSP FAS 144-c discussed by the FASB (see appendix 4), albeit criticised.

10. The staff note that the two different approaches lead to similar results for wholly owned subsidiaries as shown in the following example:

Initial interest of 100%

Scenario	**Disposal planned**	**View i**	**View ii**	**Retained investment**
Scenario 1	Disposal of 90%	HFS	HFS	Financial asset
Scenario 2	Disposal of 60%	HFS	HFS	Investment in an associate
Scenario 3	Disposal of 50%	**?**	HFU	Investment in a joint venture
Scenario 4	Disposal of 40% + participation rights	HFS	**?**	Non-controlling equity investment
Scenario 5	Disposal of 40% or less	HFU	HFU	Controlling interest

HFS: held for sale
HFU: held for use

11. For view i – scenario 3, there are two different views:

(a) Some would argue that the entity, when becoming a venturer, would jointly control its former subsidiary and may apply proportionate consolidation under IAS 31. Classification as held for sale is therefore not appropriate.

(b) Some would argue that joint control is not control and maintain that the trigger event for classification as held for sale is to have a plan involving loss of control. Classification as held for sale on the face of the balance sheet would alert users of financial statements and refer to more detailed disclosures.

12. However, these two approaches would differ for instance when the entity has an initial interest of 60% and plans to sell 20%. Under view i, classification as held for sale is justified by loss of control. Under view ii, a sale of 20% would not represent the majority of the initial interest.

Which approach do you prefer, i) or ii) ? What is your point of view on scenario 3?

b) What should be classified as held for sale when criteria are met?

13. The staff is aware of two different views on what should be classified as held for sale when criteria are met:

i. A subsidiary that is to be disposed of meets the definition of a *disposal group* as defined by IFRS 5 and therefore, all its assets and liabilities should be classified as held for sale until the disposal;

ii. Only the portion that is to be sold should be classified as held for sale.

14. The staff believe that approach i) is the only one relying on principles set out in IFRSs. IFRS 5 introduces the concept of a disposal group, which is defined as being "a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. ….". IFRS 5.4 explains further:

    Sometimes an entity disposes of a group of assets, possibly with some directly associated liabilities, together in a single transaction. Such a disposal group may be a group of cash-generating units, a single cash-generating unit, or part of a cash-generating unit.

15. It seems to the staff that a subsidiary to be disposed of, even partially, meets the definition of a disposal group. This is because a subsidiary is a group of identifiable assets and liabilities. What will be transferred in the transaction is the control over the group of assets rather than a portion of an individual asset. On disposal, all the subsidiary's assets and liabilities will be deconsolidated and a non-controlling interest will be recognised. This view is consistent with consolidation procedures set out in IAS 27 under which proportionate consolidation is not permitted.

Do you agree with the staff analysis?

c) During the held for sale period, how should the subsidiary's assets and liabilities be measured?

16. When criteria for classification as held for sale are met, paragraph 15 of IFRS 5 applies:

    An entity shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

17. The issue is whether this measurement requirement applies to <u>all</u> assets and liabilities of the subsidiary or, alternatively only to the <u>portion</u> which is to be sold.

18. The staff believe that, consistent with issue b) view i), paragraph 15 of IFRS 5 applies to <u>all</u> assets and liabilities of the subsidiary from the point of classification as held for sale to deconsolidation arising from loss of control. If the fair value less costs to sell of the subsidiary's net asset is lower than the carrying amount, a loss would be recognised during the held for sale period. On deconsolidation, there should be no material loss not previously recognised.

What are your views on this issue?

d) Is classification as discontinued operations relevant when the entity plans to retain a significant influence over its former subsidiary after the sale?

19. Under IFRSs, a disposal group classified as held for sale may also be a discontinued operation if the criteria of paragraph 32 are met, that is, when it represents a **separate major line of business or geographical area of operations**. This approach reflects the view that only a strategic shift in an entity's operations should be reported as a discontinued operation. An entity should present its discontinued operation separately on the face of the income statement and give comparative income statement and cash flow information. However, unlike US GAAP, the IFRS definition of a discontinued operation does not deal with continuing involvement.

20. Under US GAAP, when a significant influence is to be retained in the former subsidiary, the disposal should not be a discontinued operation because of the continuing involvement of the entity in the component after its disposal. In FAS 144 paragraph 43, one condition to meet the definition of a discontinued operation is that the entity will not have any **significant continuing involvement**[1] in the operations of the component after the disposal transaction. This condition would not be met in the context of this issue because, when the entity continues to be involved in the component after its disposal or the cash flows have not been (or will not be) eliminated, the component has not been disposed of economically and therefore should remain as part of continuing operations.

21. IFRSs and US GAAP are not converged but a common definition on this point is sought by the Boards (see January IASB Update) in the course of the Financial Statement Presentation project.

22. The staff's view is that the current definition of a discontinued operation could be met under IFRSs even though the entity retains a significant continuing involvement.

Do you agree with the staff analysis?

[1] EITF Issue No. 03-13 gives guidance on determining significant continuing involvement. One factor among others is that the ongoing entity retains an interest in the disposed component sufficient to enable it to exert significant influence over the disposed component's operating and financial policies.

e) After the sale of the controlling interest, how shall the remaining investment be measured?

23. When the entity sells the controlling interest in its subsidiary, the entity :

    - Deconsolidates all the subsidiary's assets and liabilities;
    - Receives consideration for the portion sold;
    - Recognises a gain or loss;
    - Recognises a non-controlling equity investment;

24. Neither IAS 27 nor IFRS 3 is clear how an entity should measure and recognise gain or loss arising on loss of control of a subsidiary in exchange for a non-controlling interest.

    IAS 27.31 An investment in an entity shall be accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement from the date that it ceases to be a subsidiary, provided that it does not become an associate as defined in IAS 28 or a jointly controlled entity as described in IAS 31.

    IAS 27.32 The carrying amount of the investment at the date that the entity ceases to be a subsidiary shall be regarded as the cost on initial measurement of a financial asset in accordance with IAS 39.

25. When referring to IASs 28 and 31, IAS 27 does not take into account that these Standards merely deal with acquisition or disposal of an investment in an associate or a joint venture. Losing control for joint control, significant influence or financial asset is not specifically dealt with within current IFRSs.

26. In fact, this measurement issue is part of the Board's project on Business Combinations. The Exposure Draft of proposed amendments of IAS 27 requires any such gain or loss to be recognised in profit or loss and any remaining non-controlling equity investment in a former subsidiary to be remeasured to its fair value in the consolidated financial statements on the date control of it is lost (see appendix 2). It is consistent with the reasoning underpinning the proposed amendment of IFRS 3 *Business Combinations,* which is the following (emphasis added):

    BC151 Paragraph 53 of the draft revised IFRS 3 requires, in a business combination achieved in stages, an acquirer to remeasure its non-controlling equity investment at its acquisition-date fair value and to recognise any unrealised gains or losses in income. This decision reflects the Board's conclusion that gaining control of a business is an event that should trigger remeasurement. Specifically, a change from

> holding a non-controlling investment in an entity to obtaining control of that entity is a significant change in the nature of the economic circumstances surrounding the investment. That change warrants a change in the classification and measurement of the investment. The Board observed that when control of the underlying entity is obtained the acquirer is no longer the owner of a non-controlling investment asset in that entity. As in present practice, the acquirer ceases accounting for an investment asset and begins reporting the underlying assets, liabilities, and results of operations of the acquiree as part of its consolidated results. In effect, the acquirer exchanges its status as an owner of an investment asset for a controlling interest in all of the underlying assets and liabilities of that acquiree. [Emphasis added]

27. The staff have quoted in appendix 2 other relevant paragraphs of both exposure drafts.

28. At the March 2006 IASB Board meeting, the discussion on this issue was summarised as follows, under the heading Business Combinations II:

    Remeasurement on achieving or losing control

    The Board affirmed the proposal in the ED that achieving or losing control of an acquiree is a remeasurement event. The acquirer remeasures any non-controlling equity investment in the acquiree it held or retains to its fair value at the date control is achieved or lost.

    The ED proposed that the acquirer should recognise in profit or loss any gain or loss on such remeasurement. Several Board members saw merit in the suggestion by many respondents that the remeasurement should be recognised in other comprehensive income. On balance, however, the Board affirmed the ED proposal.

29. The Board's current project plan envisages that a final Standard will be issued in the second half of 2007.

Do you agree with the staff analysis that current IFRSs are not clear on this issue and that it should be dealt with within the Board's project on Business Combinations?

f) What information should be disclosed in the notes to the consolidated financial statements?

30. IFRS 5 paragraph 41 b) requires entities to disclose the facts and circumstances of the sale, or leading to the expected disposal, and expected manner and timing of that disposal.

Do you believe it would give sufficient information in the context of this issue?

Assessing agenda criteria

31. This issue is widespread and has practical relevance. It is common that a group intends to dispose of some assets but wishes to retain a significant interest for at least a period of time.

32. The staff is aware of significant diversity in practice raised by the submitter, the FASB and some Agenda Committee members. The staff notes that, at least, there is potential diversity in the future as IFRSs are not altogether clear on these issues.

33. Except for the measurement issue of the retained non-controlling interest and the disclosures which are part of the project on Business Combinations, the staff believe that the IFRIC could reach a conclusion faster than the Board :

Issues	Dealt with by
a) Are criteria for classification as held for sale met?	Possibly IFRIC
b) What should be classified as held for sale when criteria are met?	Possibly IFRIC
c) During the held for sale period, how should the subsidiary's assets and liabilities be measured?	Possibly IFRIC
d) Is classification as discontinued operations relevant when the entity plans to retain a significant influence over its former subsidiary after the sale?	Possibly IFRIC
e) After the sale of the controlling interest, how shall the remaining investment be measured?	IASB
f) What information should be disclosed in the notes to the consolidated financial statements?	IASB

34. Questions to the IFRIC:

Do you agree with the staff that the IFRIC could deal with part of this issue? In that event, what outcome would you prefer: an Interpretation or a clarification through a wording for rejection dealing with the main issues raised by the submitter?

Appendix 1: the submission

[Omitted from observer notes]

Appendix 2: the Board's project on Business Combination

1) Project Summary Last Updated: August 18, 2006

ACCOUNTING AND REPORTING OF NONCONTROLLING INTERESTS AND LOSS OF CONTROL OF A SUBSIDIARY

Noncontrolling interests in subsidiaries are part of the equity of the consolidated group. Therefore: 1. Noncontrolling interests in subsidiaries should be presented in the consolidated balance sheet within equity, separate from the parent shareholders' equity. 2. Any acquisitions or dispositions of noncontrolling interests that do not result in a change of control should be accounted for as equity transactions. Consistent with the accounting for a step acquisition, if a parent loses control of a subsidiary but retains a noncontrolling equity investment in the former subsidiary, the retained noncontrolling equity investment should be remeasured to fair value and the resulting adjustment should be recognized in net income. [Emphasis added]

2) IFRS 3 and IAS 27 Exposure drafts

2.1) EXPOSURE DRAFT OF PROPOSED - Amendments to IFRS 3 Business Combinations

RECOGNISING GAINS OR LOSSES ON NON-CONTROLLING EQUITY INVESTMENTS

BC151 Paragraph 53 of the draft revised IFRS 3 requires, in a business combination achieved in stages, an acquirer to remeasure its non-controlling equity investment at its acquisition-date fair value and to recognise any unrealised gains or losses in income. This decision reflects the Board's conclusion that gaining control of a business is an event that should trigger remeasurement. Specifically, a change from holding a non-controlling investment in an entity to obtaining control of that entity is a significant change in the nature of the economic circumstances surrounding the investment. That change warrants a change in the classification and measurement of the investment. The Board observed that when control of the underlying entity is obtained the acquirer is no longer the owner of a non-controlling investment asset in that entity. As in present practice, the acquirer ceases accounting for an investment asset and begins reporting the underlying assets, liabilities, and results of operations of the acquiree as part of its consolidated results. In effect, the acquirer exchanges its status as an owner of an investment asset for a controlling interest in all of the underlying assets and liabilities of that acquiree.

BC152 Paragraph 21(b) of the draft revised IFRS 3 also provides that, for the purposes of measuring the initial fair value of the acquiree as a whole, the fair value of any non-controlling equity investment is regarded as part of the fair value of the consideration transferred. The Board noted that measuring the investment asset at its fair value at the acquisition date—when investment accounting ceases—is consistent with the concept that when one asset is exchanged for another asset the transaction is accounted for on the basis of the fair values of the assets involved (paragraph BC52).

BC153 The Board acknowledges concerns about allowing what some perceive to be an opportunity for gain recognition around the changes in status from investment to subsidiary. The Board notes that remeasurement could also result in recognising a loss. Moreover, the Board disagreed with characterising the resulting gain or loss as arising from a purchase. Rather, under the mixed attribute accounting model that exists today, economic gains and losses are recognised as they occur for some, but not all, financial instruments. If a non-controlling equity interest in an entity is not measured at its fair value, the recognition of a gain or loss at the acquisition date is merely a consequence of the delayed recognition of the economic gain or loss that is present in that financial instrument. However, if an investment asset is measured at fair value under IFRSs, the gain or loss would be recognised as it occurs, and remeasurement would result in no further gain or loss.* The Board decided to require disclosure of the gain or loss on remeasurement of any previously held non-controlling equity interest.

2.2) EXPOSURE DRAFT OF PROPOSED - Amendments to IAS 27 Consolidated and Separate Financial Statements

Paragraphs 31 and 32 of IAS 27 are deleted

Added paragraphs

30C 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 through other means, 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, if any, 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's share of gains or losses related to the former subsidiary recognised previously in consolidated equity.

The non-controlling interest's share, if any, of the carrying amount of the net assets of the former subsidiary immediately before control is lost shall be derecognised at the date control is lost with a corresponding derecognition of the carrying amount of non-controlling interest. No gain or loss shall be recognised on derecognition of the non-controlling interest.

30D On the loss of control of a subsidiary, any investment remaining in the former subsidiary shall be accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, IAS 28 or IAS 31, as appropriate, from the date control is lost. The fair value of the remaining non-controlling equity investment at the date control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with

IAS 39 or, when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

30E On the loss of control of a subsidiary, the individual assets and liabilities of that former subsidiary are derecognised. From the group's perspective, the loss of control of a subsidiary results in the loss of control and derecognition of some of the individual assets and liabilities of the group. Therefore, the gain or loss arising on loss of control of a subsidiary includes the parent's share of gains or losses that were recognized previously directly in equity. This includes the parent's share of any gains or losses:

(a) on exchange differences that were recognised directly in equity in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*;
(b) on cash flow hedges of a net investment that were recognized directly in equity in accordance with IAS 39; and
(c) related to the individual assets and liabilities: for example, available-for-sale financial assets previously recognised directly in equity, and cash flow hedge on hedging instruments previously recognised directly in equity.

Appendix 3: Extracts from FAS 144

B83. This Statement retains the requirement of Statement 121 to cease depreciating (amortizing) a long-lived asset when it is classified as held for sale and measured at the lower of its carrying amount or fair value less cost to sell. Some respondents disagreed with that requirement as also proposed in the Exposure Draft. They said that not depreciating (amortizing) a long-lived asset that is being used is inconsistent with the basic principle that the cost of a long-lived asset should be allocated over the period during which benefits are obtained from its use. The Board considered that view but affirmed its conclusion in Statement 121 that depreciation accounting is inconsistent with the use of a lower of carrying amount or fair value measure for a long-lived asset classified as held for sale because, as previously stated, accounting for that asset is a process of valuation rather than allocation.

B84. Some respondents also said that not depreciating (amortizing) a long-lived asset that is being used while it is classified as held for sale hinders the comparability of operating results during that period. They said that the comparability of operating results (reported in both continuing operations and in discontinued operations) between periods is more important than the valuation of the asset while it is classified as held for sale. The Board also considered those concerns but observed that in situations where the carrying amount of the asset (disposal group) is written down to its fair value less cost to sell, continuing to depreciate (amortize) the asset reduces its carrying amount below its fair value less cost to sell. The Board concluded that it would be inappropriate to reduce the carrying amount of the asset to an amount below its fair value. The Board further observed that because fair value less cost to sell is required to be evaluated each period, a subsequent decline in the fair value of the asset while it is classified as held for sale will be appropriately reflected in the period of decline.

Appendix 4: Proposed FSP FAS 144-c

The staff is aware that the FASB Staff have issued the Proposed FSP FAS 144-c with a comment dead line on 15 December 2006 which deals with a similar issue. The FASB staff came to the same answer regarding the classification issue but remained silent on measurement of the non-controlling interest obtained after the sale (emphasis added):

> *3. An entity shall classify the entire long-lived asset as held-for-sale and cease depreciating the long-lived asset once the long-lived asset meets the held-for-sale criteria even if the entity plans to account for its direct or indirect interest in the long-lived asset under the equity method of accounting. When the entity obtains an equity method investment, the entity will apply existing literature to determine how to account for its equity method investment. This FSP does not change the accounting for investments in joint ventures or equity method investments and whether a new basis of accounting should be applied. The Board concluded that depreciating a long-lived asset once the long-lived asset meets the held-for-sale criteria is inconsistent with FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. As discussed in paragraphs B83 and B84 of that Statement, the Board concluded that accounting for an asset classified as held-for-sale is a process of valuation rather than allocation, making depreciation inconsistent with the process of valuation.* [Emphasis added]
>
> (See appendix 3 for B83 and B84)

Out of four comment letters received (http://www.fasb.org/ocl/fasb-getletters.php?project=FSPFAS144C), three expressed concerns that the criteria for classification as held for sale would not be met because the entity retains a significant influence over the asset. Some of the arguments supporting this view are the following:

- *"The level of negotiations required for the selling entity to retain significant influence over the asset(s) being sold are such that they would call into question a conclusion that the asset(s) is available for immediate sale."* Therefore, criterion 30(b) of FAS 144 would not be met: *"The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (disposal groups).*
- *"only a fraction of ownership change could lead to a switch to equity method accounting. Classifying an asset as held-for-sale when only a percentage of that asset is sold does not appear to be consistent with the principles of FAS*

144 as we do not believe this would qualify for recognition as a completed sale as contemplated by paragraph 30d. Additionally, it seems counter-intuitive to cease depreciation while the asset is held-for-sale only to resume depreciation through the application of the equity method of accounting once the partial sale is completed"

These three respondents mainly favour classification as **held and used** with a continued depreciation rather than held for sale. They also question about measurement issues for the non-controlling interest remaining after the sale as the Proposed FSP does not address these measurement issues.

This issue will be soon re-deliberated by the TA&I Committee and discussed at the FASB meeting.