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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: **May 2007, London**

Project: **De-mergers and other in-specie distributions (Agenda Paper 8)**

ISSUE

1. In early 2006, the IFRIC was asked to provide guidance on how to account for de-mergers and other in-specie distributions *in the financial statements of the entity making such distributions to its shareholders*. The submission focuses on situations in which an entity distributes its ownership interest in its subsidiary to its shareholders and *loses control over that subsidiary*.

2. IFRSs do not address the issue at present. The IFRIC has been told by its constituents that these types of transactions are common in practice.

3. The submission states that emerging diversity in practice arises. Three alternative treatments noted in practice are:

- Distributions recorded at the *carrying amounts*;
- Distributions recorded at the *fair values*, with any difference between the fair values and the carrying amounts being recognised in *profit or loss*; and

- Distributions recorded at the *fair values*, with any difference between the fair values and the carrying amounts being recognised in *equity*.

4. Consequently, three questions have to be considered:

- How should the interest in a subsidiary be measured at the time when it is distributed? Should the interest be remeasured at fair value?
- If the interest in the subsidiary is remeasured at fair value, how should the difference between the fair value and the previously recognised carrying amount be accounted for? Arguably, the difference relates to unrecognised gains or losses of the interest distributed.

SUMMARY OF THE IFRIC'S DISCUSSION IN NOVEMBER 2006

5. At its November 2006 meeting, the IFRIC agreed that it would like to take the issue onto its agenda. However, the IFRIC noted that the accounting by an entity for the *loss of control of its subsidiary* as a result of a distribution to its shareholders of its shares might be considered as part of redeliberations on Business Combinations Phase II.

6. The IFRIC, therefore, agreed that such a project could *not* be started until after the decisions in Business Combination Phase II on loss of control were finalised.

7. An extract from the November 2006 IFRIC Update is set out in Appendix 1 to this paper.

8. The agenda paper for the November 2006 IFRIC meeting is set out in Appendix 3 to this paper.

SUMMARY OF THE IASB'S DISCUSSION IN MARCH 2007

9. At its meeting in March 2007, the Board decided *not* to address in Business Combinations Phase II the measurement basis of distributions to owners.
10. The Board tentatively decided that the revised business combinations standard should clarify that an entity should measure any retained interest in the previously controlled subsidiary at fair value at the date the control is lost.

11. An extract from the March 2007 IASB Update is set out in Appendix 2 to this paper.

PURPOSE OF THIS PAPER

12. This paper asks the IFRIC how the issue should be progressed – that is, whether the IFRIC wishes to take the issue onto the agenda.

13. This paper considers the criteria which the IFRIC should assess to determine whether an issue should be taken onto its agenda.

SHOULD THE ISSUE BE TAKEN ONTO THE IFRIC'S AGENDA?

14. The table below summaries the staff's comments on each of the criteria set out in paragraph 24 of the Due Process Handbook for the IFRIC[1]. Some of the assessment below requires the IFRIC's input, particularly criteria (d) and (e).

Criteria	Staff's preliminary assessment
a) The issue is widespread and has practical relevance.	The issue has significant practical relevance. The staff understands that there is emerging diversity in practice (see paragraph 3 of this paper).
b) The issue indicates that there are significantly divergent interpretations.	See the comments above.
c) Financial reporting would be improved through elimination of the diverse reporting methods.	'Comparability' can be enhanced if an interpretation is developed to eliminate alternative treatments.
d) The issue can be resolved efficiently within the confines of existing IFRSs and the *Framework for the Preparation and Presentation of Financial Statements*. The issue should be sufficiently narrow to be capable of interpretation.	It is intended that the discussion would focus on the *financial statements of the entity making distributions to its shareholders, and situations in which a distribution would result in the loss of control of a subsidiary*. Current IFRSs do not address the issue at all. A question arises as to whether it is possible for the IFRIC to develop an Interpretation.

[1] The Due Process Handbook for the IFRIC states that an issue does not have to satisfy all the criteria to qualify for the IFRIC's agenda.

Criteria	Staff's preliminary assessment
e) It is probable that the IFRIC will be able to reach a consensus on a timely basis.	At previous IFRIC meetings, some IFRIC members expressed concerns that the IFRIC might not be able to reach a consensus on a timely basis.
f) There is a pressing need to provide guidance sooner than would be expected from the IASB's activities.	The Board has not committed to do anything in respect of the issue.

QUESTIONS TO THE IFRIC

15. Is the issue widespread?

16. Is there any diversity in practice?

17. Given that IFRSs do not deal with de-mergers and in-specie distributions, is it possible for the IFRIC to develop an Interpretation?

18. What IFRSs will any Interpretation relate to?

19. Does the IFRIC believe that it will be able to reach a consensus on a timely basis?

20. Does the IFRIC wish to take the issue onto its agenda?

21. Does the IFRIC have any comments on the questions set out in paragraph 4 of this paper?

22. Does the IFRIC have any comments on the scope – that is, any Interpretation should focus only on the financial statements of the entity that makes the distributions?

APPENDIX 1 – RELEVANT IFRIC UPDATE (NOVEMBER 2006)

Demergers and other in specie distributions

The IFRIC received a request for guidance on the accounting for demergers and other in specie distributions in the financial statements of the entity making the distribution. The submission focused on situations in which an entity distributes its ownership interests in a subsidiary to its shareholders.

The IFRIC noted that IFRSs do not address the issue at present. The IFRIC acknowledged a need to address the issue because of the emergence of diversity in practice in respect of the basis on which in specie distributions should be recognised (ie at carrying amounts or at fair values).

The IFRIC noted that the accounting by an entity for the loss of control of its subsidiary as a result of a distribution to its shareholders of its shares in the subsidiary was being considered as part of the redeliberations on Business Combinations phase II. It was possible that in specie distributions generally would be considered in those redeliberations. The IFRIC agreed that it would like to undertake an interpretative project on in specie distributions. However, the IFRIC also agreed that a project could not be started until after the decisions in Business Combinations phase II on loss of control were finalised. The IFRIC will monitor the Board's deliberations and determine the scope of any such project, or whether a project is still required, once Business Combinations phase II has been completed.

APPENDIX 2 – RELEVANT IASB UPDATE (MARCH 2007)

Loss of control of a business resulting from a distribution to owners

The Board discussed the accounting for when an entity transfers its shares in a subsidiary to its own shareholders with the result that the entity loses controls of the subsidiary (commonly referred to as a spin-off). The IFRIC had previously discussed this matter, but decided not to take it onto its agenda while the Business Combinations project was in progress.

The Board decided not to address in phase II of the Business Combinations project the measurement basis of distributions to owners. That said, the Board tentatively decided that the revised business combinations standard should clarify that an entity should measure any retained interest in the previously controlled subsidiary at fair value at the date control is lost.

APPENDIX 3 – AGENDA PAPER FOR THE NOVEMBER 2006 IFRIC MEETING

BELOW IS THE OBSERVER NOTE FOR THE PAPER FOR THE NOVEMBER 2006 IFRIC MEETING.

INFORMATION FOR OBSERVERS

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

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

BACKGROUND INFORMATION

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

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

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

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

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

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

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

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

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

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

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

6. [Paragraph omitted from observer note].

PURPOSE OF THIS AGENDA PAPER

7. The staff notes that the proposed amendments to IAS 27[3] might address how to account for some de-mergers (in particular those involving ownership interests of

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

a subsidiary). This agenda paper sets out the relevant requirements in the proposed amendments to IAS 27.

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

REQUIREMENTS IN THE PROPOSED AMENDMENTS TO IAS 27

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

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

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

> 'Changes in the parent's ownership interest in a subsidiary after control is obtained that do not result in a loss of control shall be accounted for as transactions between equity holders in their capacity as equity holders. No gain or loss shall be recognised in profit or loss on such changes. The carrying amount of the non-controlling interest shall be adjusted to reflect the change in the parent's interest in the subsidiary's net assets. Any difference between the amount by which the non-controlling interest is so adjusted and the fair value of the consideration paid or received, if any, shall be recognised directly in equity and attributed to equity holders of the parent.'

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

> 'If control of a subsidiary is lost, whether through a sale of ownership interests in that subsidiary by the parent or members of the group or **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' share of gains or losses related to the former subsidiary recognised in consolidated equity.'

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

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

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

STAFF RECOMMENDATION

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

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

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

QUESTION TO THE IFRIC

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