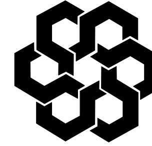

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International Accounting Standards Board

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: **November 2007, London**

Project: **Distributions of non-cash assets to owners (Agenda Paper 2)**

Introduction

1 At its meeting in September 2007, the IFRIC asked the staff to bring back to the November 2007 IFRIC meeting:

- a draft Interpretation on asset distributions to owners that reflects the conclusions reached by the IFRIC;
- a discussion of whether any difference between the carrying value of the asset distributed and the amount of the dividend payable at the time of the settlement of the dividend payable should be recognised in profit or loss or in other comprehensive income; and
- a draft of potential amendments to IFRS 5 that the IFRIC could recommend to the Board.

2 This paper consists of four sections:

- **Section 1** - An overview of the draft Interpretation. It reminds the IFRIC what has been agreed so far.
- **Section 2** – A discussion of how any difference between the carrying amount of the asset distributed and the amount of the dividend payable at the time of the settlement of the dividend payable should be recognised (ie in profit or loss or in other comprehensive income).
- **Section 3** – A discussion of how the IFRIC could require an entity to apply the requirements in IFRS 5 to a non-current asset (or disposal group) held for distribution to an entity's owners.
- **Section 4** – A discussion of how dividend reinvestment plans should be accounted for. At the September 2007 IFRIC meeting, an IFRIC member asked the staff to consider the implication of the draft Interpretation on such dividend reinvestment plans.

The purpose of this meeting

3 The staff will ask the IFRIC if:

- it agrees with the staff's conclusion that the difference between the carrying amount of the asset distributed and the dividend payable at the time of the settlement of the dividend payable should be recognised in profit or loss;
- it agrees with the staff's conclusion that the draft Interpretation can require an entity to apply IFRS 5 to non-current assets (or disposal groups) held for distribution to owners. In other words, an amendment to IFRS 5 is not necessary. If the IFRIC does not agree with the staff's conclusion, the staff will ask the IFRIC whether it agrees with the proposed amendment to IFRS 5, as set out in the appendix to the draft Interpretation;
- it wishes to include dividend reinvestment plans in the scope of the draft Interpretation; and
- it has any comments on the draft Interpretation set out in Paper 2A. [Paper 2A omitted from observer note].

Section 1 - The draft Interpretation

Conclusions reached by the IFRIC so far

4 The draft Interpretation is developed based on the decisions made by the IFRIC, as follows:

- **Definition of a distribution** – A distribution is defined as an unconditional non-reciprocal transfer of an asset by an entity to its owners acting in their capacity as owners.
- **Scope of the draft Interpretation** – It should address all non-cash asset distributions with one exception[1]. In addition, the draft Interpretation should focus on the financial statements of the entity that makes the distribution.
- **Measurement of a dividend payable** – The accounting for all dividends payable should be dealt with by a single standard. Regardless of the types of the assets to be distributed, all liabilities for such dividends payable should be measured in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In accordance with IAS 37, an entity has to consider the fair value of the assets to be distributed in determining the best estimate for the dividends payable. No exceptions should be made to this measurement principle.
- **Settlement of a dividend payable** – At the time an entity distributes the assets to its owners, any difference between the carrying amount of the assets distributed and the carrying amount of the dividends payable should be recognised in comprehensive income (*not an owner change in equity*). The IFRIC noted that the difference is normally a credit balance because the carrying amount of the assets distributed would not normally be greater than the carrying amount of the dividends payable determined in accordance with IAS 37 (referred to below as the credit balance). Section 2 discusses whether the credit balance should be recognised in profit or loss or in other comprehensive income.

[1] The draft Interpretation does not apply to a distribution of an asset that is ultimately controlled by the same parent entity before and after the distribution (see paragraph 5 of the draft Interpretation).

Section 2 - How should an entity recognise the credit balance (ie in profit or loss or in other comprehensive income)?

5 In the discussion below, references to IAS 1 *Presentation of Financial Statements* are to IAS 1 (as revised in 2007) that will be effective for annual periods beginning on or after 1 January 2009.

6 Under IAS 1, changes in equity are categorised into two types: one is owner changes in equity and the other is non-owner changes in equity. The latter category is referred to as comprehensive income. IAS 1 further divides comprehensive income into two components: items of profit or loss and items of other comprehensive income.

7 At its meeting in September 2007, the IFRIC decided that the credit balance should be recognised as an item of comprehensive income (*not an owner change in equity*). This is because: (a) the credit balance is clearly *not* a contribution from an entity's owners, and (b) the credit balance represents the cumulative unrecognised gains associated with the assets. Such cumulative unrecognised gains reflect the performance of the entity during the period the assets were held.

8 Moreover, the staff noted that, in paragraph BC53 of the Basis for Conclusions on IAS 1, the Board clearly prohibits any income or expenses (ie non-owner changes in equity) from being presented directly in the statement of changes in equity. Those income or expenses have to be recognised in the statement of comprehensive income first.

9 Therefore, the discussion below focuses on whether the credit balance should be recognised as an item of profit or loss or an item of other comprehensive income.

10 The draft Interpretation proposes that the credit balance should be recognised as an item of profit or loss.

Major arguments for the recognition of the credit balance in profit or loss

11 When an entity distributes its assets to its owners, it loses the future economic benefits associated with the assets distributed and derecognises them. Such a consequence is similar to that of a disposal of an asset. In general, IFRSs (eg IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 39

Financial Instruments: Recognition and Measurement) require an entity to recognise any gain or loss arising from the derecognition of an asset in profit or loss.

12 In addition, paragraph 88 of IAS 1 states: 'An entity shall recognise all items of income and expense in a period in profit or loss *unless an IFRS requires or permits otherwise (emphasis added).*' Such a requirement indicates that profit or loss is the default category. Recognising any income or expenses as items of other comprehensive income must be explicitly required or permitted by other IFRSs.

13 The staff has reviewed relevant IFRSs that require income or expenses to be recognised as items of other comprehensive income. With the exception of revaluation surplus or deficit on property, plant and equipment or intangible assets, income or expenses recognised as items of other comprehensive income are required to be reclassified to profit or loss when the related assets or liabilities are derecognised. Examples are changes in the fair value of an available-for-sale asset and exchange differences arising from the translation of the results, assets and liabilities of a foreign operation. Those changes are recognised as items of other comprehensive income when incurred, deferred in equity until the related assets are disposed of, and reclassified to profit or loss when the related assets are disposed of.

14 When an entity distributes its assets to its owners, it has to derecognise the assets distributed. Therefore, even if the credit balance was recognised as an item of other comprehensive income, it would have to be reclassified to profit or loss *immediately*. Given the existing requirements in IFRSs, it would be extremely difficult to argue that the credit balance does not have to be recycled.

15 Furthermore, even if the credit balance were recognised as an item of other comprehensive income and was reclassified to profit or loss immediately, the credit balance would appear three times in the statement of comprehensive income — once recognised as an item of other comprehensive income, once reclassified out of other comprehensive income to profit or loss and once recognised as an item of profit or loss as a result of the reclassification. The staff does not believe such a presentation faithfully reflects what has happened. In addition, users of financial statements would likely be confused by such a presentation.

16 Paragraphs BC27-41 in the Basis for Conclusions on the draft Interpretation explain in detail why the credit balance should be recognised as an item of profit or loss, rather than as an item of other comprehensive income.

Questions for the IFRIC

17 Does the IFRIC agree with the staff's conclusion that the credit balance should be recognised in profit or loss?

Section 3 - Is an amendment to IFRS 5 necessary?

18 At its meeting in September 2007, the IFRIC asked the staff to draft a proposed amendment to IFRS 5 so that non-current assets (or disposal groups) that are held for distribution to owners are measured and presented consistently with assets (or disposal groups) that are classified for held for sale in accordance with IFRS 5.

19 In particular, the IFRIC believed that the disclosures applicable to a discontinued operation in IFRS 5 are useful to users of financial statements to enable them evaluate the potential financial effects of a distribution of an operation to owners.

20 The staff reconsiders whether it is necessary to amend IFRS 5. Another possible alternative is to include in the draft Interpretation a requirement to apply the measurement and presentation provisions in IFRS 5. In principle, IFRS 5 applies to a non-current asset (or disposal group) that its carrying amount will no longer be recovered principally through continuing use. The form of a transaction should not affect the applicability of IFRS 5. In addition, IFRS 5 defines a disposal group as a group of assets to be disposed of, by sale *or otherwise* together with as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

21 The staff has included in the draft Interpretation two alternatives:

- Alternative 1 – No amendment to IFRS 5. Instead, the draft Interpretation includes a requirement to require an entity to apply IFRS 5 to a non-current asset (or disposal group) held for distribution to owners (see paragraphs 13-15 of the draft Interpretation and paragraphs BC42-45).

- Alternative 2 – An amendment to IFRS 5 (see the appendix to the draft Interpretation and paragraphs BC42-46).

Questions for the IFRIC

22 Which alternative does the IFRIC prefer?

23 If the IFRIC prefers Alternative 2, does the IFRIC have any comments on the proposed amendment to IFRS 5 set out in the appendix to the draft Interpretation?

Section 4 - Dividend reinvestment plans

24 At the September 2007 IFRIC meeting, an IFRIC member asked the staff to consider the implications of the requirements in the draft Interpretation on dividend reinvestment plans.

25 As background, the staff reviewed the dividend reinvestment plans of several listed entities.

26 Common features of the dividend reinvestment plans reviewed are:

- An entity declares a cash dividend of a fixed amount to its owners at the date of declaration.
- Owners are asked whether they would like to receive a fixed amount of cash or would like the cash dividend to be reinvested in the equity instruments of the entity. If owners choose to receive equity instruments, the number of equity instruments they will receive depends on (a) the amount of the cash dividend, and (b) the market price of the equity instrument at a date between the date of declaration and the date of settlement (usually close to ‘record date’ or ex-dividend date’).

- To deliver the equity instruments to its owners, the entity may purchase them in the market or issue them.
- The purpose of such dividend reinvestment plans is to allow owners to reinvest the cash dividend in the equity instruments of the entity.

The staff's view

27 The distribution is essentially a cash distribution. Such a reinvestment plan merely gives owners a choice to reinvest the cash dividend in the equity instruments of the entity. Such a choice is not relevant in determining how the cash distribution should be accounted for.

28 In addition, in accordance with IAS 32 *Financial Instruments: Presentation*, a contract that requires an entity to deliver a variable number of its equity instruments for a fixed amount is classified as a liability.

29 When an entity settles the dividend payable by issuing its equity instruments, it should record the following entry:

DR Dividends payable (the fixed amount of the cash dividend)
CR Share capital[2]

No gain or loss should be recognised in profit or loss (see AG32 of IAS 32).

Questions for the IFRIC

30 Does the IFRIC agree with the staff's view? If not, why not?

31 Does the IFRIC want the draft Interpretation to address how an entity should account for a dividend reinvestment plan? If the IFRIC wants to do so, the staff could include in the draft Interpretation a statement that, when an entity has an obligation to make a distribution to its owners that gives them a choice of receiving a fixed amount of cash or and a variable number of shares of an equivalent amount, the entity should recognise a liability for the entire dividend.

[2] This may be split between share capital and other paid in capital (eg if an entity has par value share capital).