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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: **September 2007, London**

Project: **Any exceptions to the measurement principle proposed in Paper 2A? (Agenda Paper 2C)**

INTRODUCTION

1. Paper 2A discusses how an entity should measure non-cash distributions by reference to how it should measure the corresponding dividends payable in accordance with IFRSs. Paper 2A suggests that the entity should consider the fair values of the assets to be distributed in determining the carrying amount of its dividends payable.

2. Some are concerned that the fair value of the assets to be distributed might not be reliably measurable in all cases. Therefore, they believe that there should be exceptions to the measurement principle.

3. In the staff's view, any exceptions might require amendments to IAS 37 and/or IAS 39 (ie scope exclusions).

4. This paper does not consider whether exceptions should be made in situations in which an entity distributes tangible assets (eg property, plant and equipment, investment properties) to its equity holders. The staff does not expect significant difficulties to arise in determining the fair values of tangible assets.

THE PURPOSE OF THIS PAPER

5. This paper considers whether any exceptions to the measurement principle should be made in the following two situations in which the fair value of the assets concerned might not be reliably measured:

   - **Situation 1 –** An entity distributes an ownership interest in another entity to its equity holders. The ownership interests of the latter entity *are not traded in active markets and the fair value of the ownership interests cannot be reliably measured*.

   - **Situation 2 –** An entity distributes an intangible asset to its equity holders. The intangible asset is *not recognised* in the financial statements of the entity *because IAS 38 does not permit its recognition*.

6. If exceptions are made, the staff proposes that the entity would measure non-cash distributions and the corresponding dividends payable based on the carrying amounts of the assets concerned. Hence, there is no profit or loss effect.

7. This paper asks whether the IFRIC wishes to make exceptions for these two situations and the reasons for the exceptions to be included in the Basis for Conclusions.

8. In addition, this paper considers a situation in which the purpose of the distribution is to establish another group structure (eg to separate different businesses into different groups) rather than to genuinely distribute ‘something’ valuable to the equity holders. In the consolidated financial statements of the ultimate parent of the entity, there is no change in ownership interests in the subsidiary.

9. This paper asks:

- whether the IFRIC wishes to include such a situation in the scope of the project; and
- if so, whether the IFRIC wishes to measure the distributions based on the proposed requirement set out in Paper 2A.

SITUATION 1 – AN ENTITY DISTRIBUTES AN OWNERSHIP INTEREST OF ANOTHER ENTITY WHOSE THE FAIR VALUE CANNOT BE MEASURED RELIABLY

10. The table below summarises possible arguments for and against exceptions for Situation 1.

Arguments for exceptions	*Arguments against exceptions*
IAS 39 paragraph 46(c) requires investments in equity instruments that do not have a quoted market price in an active market and whose fair values cannot be measured reliably to be carried at cost. Therefore, some argue that, when there is clear evidence that the fair value of the ownership interest cannot be measured reliably, the distribution and the corresponding dividend payable should be measured based on the carrying amount of the ownership interest to be distributed.	The exception does not reflect the 'true' value of the distribution. In addition, when the management recommends certain assets be distributed to the equity holders, it should know the fair value of the distributions. The management of an entity *has the fiduciary duty* to (i) inform the equity holders the 'true' value of the distributions and (ii) ensure that all equity holders of the entity within the same class are treated equally. Moreover, 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: • explanation of why fair value cannot be measured reliably; and • at the time of derecognition, the carrying amounts of the assets derecognised and the amount of gain or loss recognised. Given that the management of an entity has the fiduciary duty to treat all equity holders of the same class equally, it might be difficult for the entity to argue that the fair value of the assets to be distributed cannot be measured reliably.

Questions for the IFRIC

11. Does the IFRIC wish to provide an exception for Situation 1? Why?

12. If the IFRIC believes that an exception should be made, what disclosures would the IFRIC require to be made in the notes to the financial statements?

SITUATION 2 – AN ENTITY DISTRIBUTES AN INTANGIBLE ASSET

13. The table below summarises possible arguments for and against exceptions for Situation 2.

Arguments for exception	***Arguments against exception***
Paragraph 75 of IAS 38 requires the fair value of an intangible asset to be determined by reference to an active market. Hence, IAS 38 generally does not permit intangible assets for which there is no active market to be measured using the revaluation model. As a result, some argue that, if an entity distributes an intangible asset for which there is no active market, the entity should measure the distribution and the corresponding dividend payable based on the carrying amount of the intangible asset. In addition, some are concerned that, if no exceptions are made, there would probably be significant profit or loss effect at the time the entity distributes the assets.	The exception would probably result in the distribution and the corresponding dividend payable being recorded at ***nil***. Obviously, such an accounting treatment does not reflect the 'true' value of the distribution. In addition, as mentioned above, the management has the fiduciary duty to inform the equity holders the 'true' value of the distribution. Hence, the management should know the fair value of the distribution. Moreover, paragraph 33 of IAS 38 requires intangible assets acquired in a business combination to be measured at their fair values at the date of acquisition. 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 also takes into account the fair values of the intangible assets. Therefore, it is difficult to argue that fair values of intangible assets cannot be determined reliably. In respond to the potential profit or loss effect, as mentioned in Paper 2B, the difference between the carrying amount of the dividends payable and the carrying amount of the assets distributed reflects the performance of the entity and belongs to the entity before the assets are distributed. Hence, the difference should be recognised in profit or loss when the assets are distributed.

Questions for the IFRIC

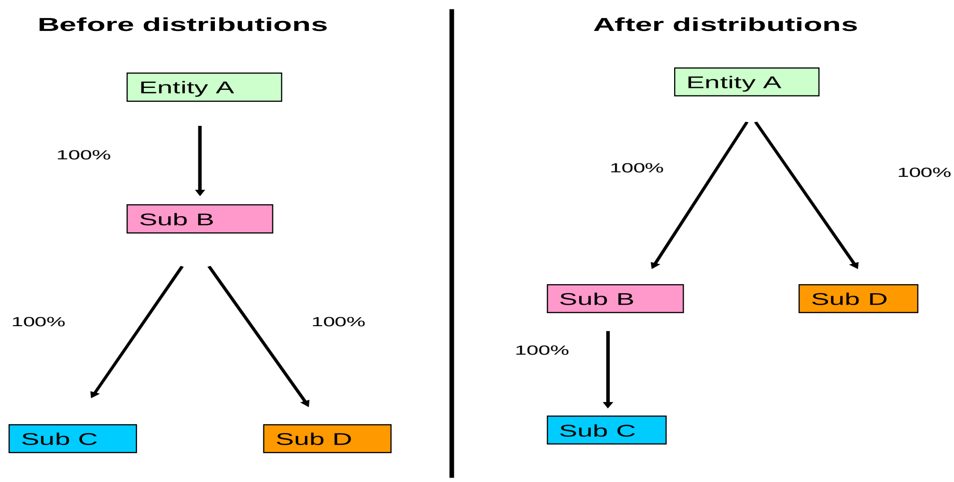
14. Does the IFRIC wish to provide an exception for Situation 2? Why?

15. If the IFRIC believes that an exception should be made, what disclosures would the IFRIC require to be made in the notes to the financial statements?

SITUATION 3 - THE PURPOSE OF THE DISTRIBUTION IS *TO ESTABLISH ANOTHER GROUP STRUCTURE*

16. In some circumstances, an entity might distribute an ownership interest in its subsidiary to its equity holders. The purpose of such a distribution is to establish another group structure (eg to separate two different businesses into two different subgroups).

17. The diagram below illustrates an example:



18. The facts of the above example are as follows:

- Sub B distributes all of its ownership interest in Sub D to Entity A. The purpose of the distribution is for group restructuring so that Sub C and Sub D engaging in two different businesses will no longer be operating in the same subgroup.
- From the perspective of Entity A, it still controls and has the same economic benefits from Sub D.

19. Because of the nature of the transaction, some believe that Sub B should measure the ‘distribution’ and the corresponding ‘dividend payable’ based on the carrying amount of the ownership interest recorded in its financial statements.

20. The table below summarises possible arguments for and against exceptions for Situation 3.

Arguments for exception	***Concerns over exception***
From the perspective of Entity A, nothing has changed. The 'distribution' has no effect on the consolidated financial statements of Entity A.	However, Sub B has lost control over and the future economic benefits from Sub D. In addition, financial statements are *general purpose* financial statements that are prepared for a wide range of users (not just equity holders). At the July 2007 IFRIC meeting, the IFRIC agreed that the effect of a transaction should be considered from the perspective of an entity for which the financial statements are prepared. Such a conclusion is based on the requirement set out in paragraph 12 of the Framework[1].
The transaction is primarily for the purpose of group restructuring.	Some are concerned that it is difficult to verify whether a 'distribution' is genuinely for group restructuring. Arguably, it is based on the intent of the management and equity holders. If an exception is made in this situation, some believe that the exception must be highly restrictive to the following situation: • the management should demonstrate with an authorised plan that the 'distribution' is for group restructuring purposes; and • the ultimate holding parent (ie Entity A in the above example) has the same ownership interest before and after the distribution.

[1] Paragraph 12 of the Framework states: 'The objective of the 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.'

Questions for the IFRIC

21. Does the IFRIC wish to provide an exception for Situation 3? Why or why not?

22. If the IFRIC believes that an exception should be made in Situation 3,

    - Does the IFRIC wish to restrict the exception to the situation described in paragraph 20?
    - What disclosures would the IFRIC require to be made in the notes to the financial statements?

23. If the IFRIC cannot reach consensus on this matter, the IFRIC might consider not including Situation 3 in the scope of the project. The IFRIC could explain the scope exclusion because the Board is now considering whether it should take a project relating to a business combination under common control on to its agenda.