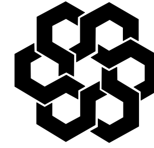

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

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 2008, London**
Project: **D23 *Distribution of Non-cash Assets to Owners* – Accounting mismatch (Agenda Paper 3D)**

Introduction

1 The IFRIC recognised respondents' concerns about the potential 'accounting mismatch' in equity resulting from measuring the assets to be distributed at carrying amount and measuring the dividend payable at their higher fair value. (The issue does not arise if fair value is lower than carrying amount as the assets will be written down at the same time as the dividend is recognised.) Consequently, the IFRIC directed the staff in its July meeting to consider whether it should recommend that the Board amend IFRS 5 to require the assets to be distributed to be measured at fair value. The staff were also asked to consider any potential implications or consequences of such a conclusion for other standards.

Should the IFRIC recommend that the Board amend IFRS 5 to require the assets to be distributed to be measured at fair value?

2 Based on the idea to amend IFRS5, the journal entry is as follows:

Journal entry:

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

To remeasure the assets to be distributed at fair value

3 The IFRIC discussed in the July 2007 meeting what triggers remeasurement of the assets (see Appendix 1). As a result of the discussion, the IFRIC did not agree with the view that the decision to distribute the assets should trigger remeasurement of the assets because they could not find any IFRS literature that supported an increase in value as a result of a management decision. The IFRIC also noted that the mismatch concerned arises only with respect to assets that are not carried at fair value already

4 In general, IFRSs permit remeasurement of assets only as the result of a transaction or an impairment. The exceptions are situations in which the standards prescribe current measures on an on-going basis, as in IASs 39 and 41, or permit them as accounting policy choices, as in IASs 16, 38 and 40. .

5 If a business is to be distributed, the fair value means the fair value of the business to be distributed. Therefore, it includes goodwill and intangible assets.

6 However, internally generated goodwill shall not be recognised as an asset (paragraph 48 of IAS38). Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets (paragraph 63 of IAS38). Under IAS 38, the carrying amounts of internally generated intangible assets are generally restricted to the sum of expenditure incurred by an entity.

7 Consequently, a requirement to remeasure an asset that is a business apparently contradicts the relevant requirements in IAS 38.

8 Further, in addition to the lack of consistency with other standards, changing IFRS 5 to require an asset to be distributed to be remeasured at an increased fair value would cause internal inconsistency within IFRS 5. There would be no reasonable rationale to explain why IFRS 5 could require assets that are to be sold to be carried at the lower of fair value and carrying value but assets to be distributed to owners to be carried at fair value.

9 Therefore, the staff do not recommend that the Board be asked to amend IFRS 5 to require the assets to be distributed to be measured at fair value.

Question for the IFRIC

10	Do you agree with staff recommendation in paragraph 9? If not, how do you explain the apparent contradiction with IAS 38? Have you identified any IFRS literature that would support an upward remeasurement other than that the IFRIC considered and rejected in 2007?

How should the IFRIC deal with accounting mismatch issue?

11 Appendix 2 to this paper illustrates the difficulty of applying the draft Interpretation (CL23 Ernst & Young). The staff acknowledges this practical difficulty particularly when the entity does not have sufficient distributable profits (for example, in the case of the split-off of the entity as a way of corporate recovery).

12 Now, the only remaining *theoretical* ways (but similar to the US GAAP) to avoid this issue would focus more on the asset side:

Alternative 1: recognise liability at carrying value and recognise profit and loss on settlement:

Journal entry 1:

DR	Equity	CA	
CR	Liability		CA

To recognise the liability at the carrying amount of the assets when obligated

Journal entry 2:

DR	Liability	CA	
	Equity	FV-CA	
CR	Assets		CA
	Profit and Loss		FV-CA

To record the distributions to equity holders and recognise P/L

Alternative 2: recognise no liabilities during process

Journal entry 1:

None

Journal entry 2:

DR	Equity	FV	
CR	Assets		CA
	Profit and Loss		FV-CA

To record the distributions to equity holders.

13 These alternatives are different from the IFRIC's decision to recognise the liability when the entity is obligated and to measure the liability at the fair value of the assets to be distributed.

14 The staff is of the view that the accounting mismatch is the inevitable consequence of using different measurement attributes at different times with different triggers for the remeasurement of different assets and liabilities. There is asymmetry in

current IFRSs for the measurement of assets and liabilities. IFRSs inherently lead to accounting mismatches whenever liabilities are carried at current values and related assets are not remeasured.

15 Therefore, the staff do not recommend that the IFRIC reverse its earlier fundamental conclusions and adopt one of the alternatives.

Question for the IFRIC

16 Do you agree with staff recommendation in paragraph 15? If not, what is your proposed solution to the accounting mismatch issue?

17 Do you agree with drafting in the Basis of Conclusions in BC 50 to 53?

Appendix 1- Extract from the July 2007 IFRIC papers

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 distribution 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[1] 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.

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[1] Alternative 2 here is assets distributed should be remeasured at the time of distribution.

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.

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).

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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.

Appendix 2- Illustration of the difficulty of applying the draft interpretation in the separate financial statements

In many jurisdictions, the distribution of dividends is limited to the amount of recognised profits.

As the liability is created, equity is reduced. If there are insufficient profits recognised at that date - despite the fact that the asset's fair value is greater than its carrying value - the regulation would not permit the dividend to be paid.

Alternatively, while there may be sufficient profits to create a liability for the dividend, subsequent increases in the fair value of the asset may result in there being insufficient profits by the time that the distribution is to be made - hence the regulation would not permit the dividend to be paid. This is illustrated in the following example:

	Year end	**Declaration Date**	**Settlement Date**
Distributable profits	1500	1500	1500
Distribution declared		1400 100 surplus	
Asset's carrying amount	1000		1000
Asset's fair value	1200	1400	1600 100 deficiency

In this case the 'declared' dividend (increased to 1600 at the time of settlement) is greater than the profits recognised to date, hence the entity will not be able to make the distribution. The profit of 600 is only recognised as result of the dividend payment itself (the settlement of the liability) hence cannot be taken into account in the calculation.