Project **Annual Improvements Process**

Topic **Application of IFRS 5 in a step acquisition and in loss of significant influence over an associate or a jointly controlled entity**

Background

1. Two issues are identified:

    (a) Issue 1: Should an entity classify as held for sale an associate or a jointly controlled entity in accordance with IFRS 5 when it is highly probable that the entity will lose significant influence or joint control (step-down)?

    (b) Issue 2: Should an entity classify as held for sale an associate or a jointly controlled entity in accordance with IFRS 5 when it is highly probable that control will be obtained (step-up)?

2. In *Improvements to IFRSs* issued in May 2008, the Board amended IFRS 5 to clarify that an entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out in paragraphs 6-8 of IFRS 5 are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

3. The IASB has been asked to clarify the applicability of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* to an associate or jointly controlled entity when it is highly probable that control will be obtained and/or significant influence or joint control will be lost.

Staff recommendation

4. The staff recommends that the Board:

   (a) address the issue in the annual improvements project;

   (b) amend IFRS 5 to clarify that the entity classifies as held for sale an associate or a jointly controlled entity when it is highly probable that joint control or significant influence will be lost.

Staff analysis

Step-down

5. The staff agrees that IFRS 5 applies to the loss of significant influence or joint control of an investee because the Board concluded that the loss of control of an entity and the loss of significant influence/joint control over an entity are economically similar events. In other words, the loss of significant influence or joint control meet the IFRS 5 requirement that an entity intends to sell and the entity should reclassify the investment as held for sale.

6. The staff recommend that, given the apparent lack of clarity in IFRS 5, the Board should amend IFRS 5 to make it clear that an interest an entity has in an associate or jointly controlled entity is classified as held for sale if the entity is committed to a sale plan involving loss of significant influence or joint control.

7. Some staff think such an amendment is not necessary because the requirements are clear. Those staff would prefer that the Board refer the matter to the IFRIC before any decision is made to amend IFRS 5.

Staff recommendation and question to the Board
The staff recommends that the Board: 1) address this issue in the annual improvements project; 2) add a new paragraph in IFRS 5 to clarify that the entity classifies as held for sale an associate or a jointly controlled entity when it is highly probable that significant influence or joint control will be **lost.** Do you agree with the staff recommendation? If not, why?

Step-up

8. When the acquirer obtains control of an acquiree in stages (referred to as step acquisition), there are two views on the application of IFRS 5 to the existing shares of the associate:

   (a) **View 1 -** Some think that IFRS 5 applies to the investment because there is a significant change in the nature of the investment; and there is an exchange of assets (ie. the investment in the associate is derecognised and a new asset of a different nature is recognised).

   (b) **View 2 -** Others think that IFRS 5 does not apply to the investment because the acquirer does not sell the investment but purchases additional interests in the investment; and classifying an investment as held for sale in a step acquisition does not provide useful information and could be potentially misleading about the future cash flows.

9. For example, on 31 December 20X1, Entity A holds a 35 per cent non-controlling equity interest in Entity B. On that date, the management of Entity A commits to a plan to purchase an additional 40 per cent interest in Entity B, which gives it control of Entity B. Supporters of View 1 think that IFRS 5 applies to the existing 35 per cent interest and that the 35 per cent interest should be classified as held for sale. Supporters of View 2 would not report the investment as being held for sale.

View 1

10. The supporters of View 1 note that IFRS 3 paragraph 42 requires the re-measurement of previously held interests when a business combination is achieved in stages. IFRS 3 BC384 explains that because a significant change in the nature of and economic circumstances surrounding that investment occurs, that change warrants a change in the classification and measurement of that investment, and that the acquirer is no longer the owner of a non-controlling investment asset in the acquiree. IFRS 3 BC389 states: “In a business

combination achieved in stages, **the acquirer derecognises its investment asset in an entity in its consolidated financial statements when it achieves control.** Thus, the boards concluded that it is appropriate to recognise any resulting gain or loss in profit or loss at the acquisition date" [emphasis added].

11. For an entity that is committed to a sale plan involving the loss of control of a subsidiary, the Board clarified in IFRS 5 BC24A to BC24E that **loss of control is a significant economic event that changes the nature of an investment** and that at the date control is lost, **all the subsidiary's assets and liabilities are derecognised and any investment retained in the former subsidiary is recognised** [emphasis added]. The Board concluded that, under the sale plan, the controlling interest in the subsidiary is, in substance, exchanged for a non-controlling interest.

12. The supporters of View 1 also note that IAS 28 BC21 (added in 2008) states: "In the second phase of the Board's project on business combinations, the Board observed that **the loss of control of an entity and the loss of significant influence over an entity are economically similar events**; thus they should be accounted for similarly" [emphasis added]. IAS 31 BC16 (added in 2008) states the same.

13. They also note that IAS 21 48A was added in phase II of the boards' project on business combinations to clarify that: "In addition to the disposal of an entity's entire interest in a foreign operation, the following are accounted for as disposals even if the entity retains an interest in the former subsidiary, associate or jointly controlled entity:

    (a) the loss of control of a subsidiary that includes a foreign operation;

    (b) **the loss of significant influence** over an associate that includes a foreign operation; and

    (c) **the loss of joint control over a jointly controlled entity** that includes a foreign operation." [emphasis added]

14. The supporters of View 1 think that the requirements quoted above are based on the boards' conclusion that when there is a loss or gain of control and/or a loss of significant influence or joint control:

(a) there is a significant change in the nature of the investment; and

(b) there is an exchange of assets[1] (ie. an asset is derecognised and a new asset of a different nature is recognised).

15. They believe that this rationale is equally applicable to IFRS 5, although they admit that application of IFRS 5 to a gain of control in a step acquisition seems counter-intuitive. Therefore, an entity should classify as held for sale an associate or a jointly controlled entity when it is highly probable that the investment will be derecognised because control will be obtained. They believe that any other conclusion regarding the applicability of IFRS 5 (as discussed in paragraphs 13-15 below) could be inconsistent with the requirements in IAS 27, 28 and 31 and the earlier amendment of IFRS 5 as part of the annual improvements project.

View 2

16. The supporters of View 2 believe that IFRS 5 should apply to the loss of significant influence and joint control, but not to the derecognition of an investment as a result of gaining control in a step acquisition. They believe that the held-for-sale classification applies only to an asset or disposal group that an entity intends to sell. IFRS 5 states in paragraph 6 that an entity classifies a non-current assets … as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Even though IFRS 3 requires an entity to account for a step acquisition as an exchange of investments, the entity does not have the intention or commitment to sell the investment. In contrast, the intention is to acquire additional shares. IFRS 3 requires the acquirer to remeasure any investment held immediately before achieving control, however, it is not a sales transaction.

[1] For an exchange of assets, IFRS 5 paragraph 10 states: Sale transactions include exchanges of non-current assets for other non-current assets when the exchange has commercial substance in accordance with IAS 16 Property, Plant and Equipment. BC36 states “Consistently with IAS16, the IFRS treats an exchange of assets **as a disposal and acquisition of assets** unless the exchange has no commercial substance.”

17. In addition, they believe that classifying an investment as held for sale in a step acquisition does not provide useful information and could be potentially misleading. The underlying basis of IFRS 5 for a separate classification of assets as held for sale is that providing information about assets to be disposed of benefits users in assessing the timing, amount and uncertainty of future cash flows (IFRS5.BC17). Classifying an intended step acquisition does not serve this purpose because the entity will have rather more than less certainty on future cash flows as it will gain control in the future.

18. In addition, IFRS 5 requires assets that are held for sale to be measured at the lower of cost or fair value less cost to sell. In a step acquisition, for instance from an associate to a subsidiary, an entity will classify the investment as held for sale and stop applying the equity method (IAS 28.14). Accordingly the entity will not recognise its share of the associate's profit in the period the profit was generated. Instead, it will recognise the share of profit as part of the gain on re-measurement of a previously held interest in the period it obtains the control of the subsidiary. The application of IFRS 5 in a step acquisition will therefore distort the operating result of the entity.

Recommendation and question

Staff recommendation and question to the Board
3) Which view do you support whether the entity should classify as held for sale an investment (including associate or a jointly controlled entity) (**View 1**) or not (**View 2**) when it is highly probable that control will be obtained? The discussion on this issue will be added to the Basis for Conclusions.

Appendix A – Proposed amendments to IFRS 5

Paragraph 8A is amended (newly added text is underlined).

8A An entity that is committed to a sale plan involving loss of control of a subsidiary <u>or loss of significant influence of an associate or joint control of a jointly controlled entity</u> shall classify all the assets and liabilities of that subsidiary <u>or all the interests in an associate or a jointly controlled entity</u> as held for sale when the criteria set out in paragraphs 6-8 are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary <u>or an interest in the former associate or jointly controlled entity</u> after the sale.