Project	**IAS 21 *The Effects of Changes in Foreign Exchange Rates***
Topic	**Repayment of investment / CTA**

Introduction

1. At the March 2010 meeting, the Committee began preliminary discussions on an issue in IAS 21 *The Effects of Changes in Foreign Exchange Rates* related to when the separate foreign currency equity reserve related to the retranslation of the net assets of an investor's net investment in a subsidiary (often referred to as 'CTA') should be recycled. That preliminary discussion was based on the staff research and analysis included in the March 2010 Committee Agenda Paper 7D[1].

2. The submission requests the Board address this issue as part of the *Annual Improvements* project (AIP). However, given the recent changes to AIP and the Committee's involvement, this issue is being presented first for deliberation by the Committee.

3. The purpose of this Agenda Paper is provide to:

   (a) **Background** of the issue;

   (b) **Staff analysis and recommendations**; and

   (c) **Questions for the Committee**.

[1] Observer Note 7D is available at http://www.iasb.org/Meetings/IFRIC+Meeting+March+2010.htm

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IFRIC.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRIC or the IASB. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

Background

4. As the staff explained in paper 7D at the March Committee meeting the primary issue being asked is in its opinion <u>when should the separate foreign currency equity reserve related to the retranslation of the net assets of a net investment (NI) (often referred to as 'CTA') be recycled</u>. More specifically, should CTA be recycled for transactions in which there is a reduction in:

   (a) **View 1 –** the **proportionate** (relative) equity ownership interest in a foreign operation; or

   (b) **View 2 –** the **absolute** interest of an entity's ownership interest in a foreign operation, but no reduction in the proportionate equity ownership interest in a foreign operation.

5. The staff does not think that situations which involve both reduction of proportionate and absolute parts of the net investments should be considered when addressing this request as those transactions should certainly require recycling of CTA under current IAS 21.

6. The issue arises because, in the submitter's opinion, the guidance in paragraphs 48–49 of IAS 21 is unclear. Specifically the guidance in paragraph 48D states that 'A partial disposal of an entity's interest in a foreign operation <u>is any reduction in an entity's ownership interest in a foreign operation</u>…'

IFRIC submission

7. The submission is included in Appendix C without modification for reference (except for removal of submitter contact information).

8. It should however be noted that the submission only addressed a situation where a subsidiary is 100% owned by a parent and remains 100% owned. The discussions by staff in this paper are not limited to these circumstances and staff have therefore broadened the issue to deal with all reductions in a net investment in foreign operations.

Staff Analysis and Recommendations

General information

9. IAS 27 *Consolidated and Separate Financial Statements* (revised 2008) states, in part:[2]

> **Disposal or partial disposal of a foreign operation**
>
> 48 **On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation, recognised in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised (see IAS 1 *Presentation of Financial Statements* (as revised in 2007)).**
>
> 48A 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.
>
> 48B On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be derecognised, but shall not be reclassified to profit or loss.
>
> **48C On the partial disposal of a subsidiary that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation the entity shall reclassify to profit or loss only the proportionate share of the cumulative amount of the**

[2] The fortcoming IFRS on *Joint Arrangements* will change paragraph 48A of IAS 21. The proposed revised paragraph is included in Appendix D.

exchange differences recognised in other comprehensive income.

48D A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except those reductions in paragraph 48A that are accounted for as disposals.

49 An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity. A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

Types of CTA

10. In the staff opinion there are two types of foreign exchange differences:

    (a) Direct foreign exchange differences;

        (i) quasi equity loan can create foreign exchange difference directly when denominated in investee's functional currency rather than the parent's functional currency. However, such foreign exchange difference should be tracked separately and recycled when the loan is repaid.

    (b) Indirect foreign exchange differences;

        (i) foreign exchange difference created indirectly, when investee's net assets are converted from investee's functional currency to group presentation currency.

11. Staff thinks that accounting for recycling of direct foreign exchange differences is clear. Therefore in this paper the staff focus is on accounting for indirect foreign exchange differences.

Accounting for indirect foreign exchange differences

View 1 – Recycle CTA when proportionate reduction

12. View 1 supports that amounts recognised in CTA related to a foreign operation are recycled only when there is a reduction in the entity's proportionate ownership interest in the foreign operation. Therefore under this view 'ownership interest' is defined as the proportionate interest in the foreign operations.

13. View 1 is also consistent with the IAS 27 as revised. Under IAS 27 gain and loss on disposal arises only when a parent loses control and not if ownership interest is reduced, in either percentage or absolute terms. Consistent with this rationale, there is no recycling of CTA for the partial disposal through sale or liquidation/ abandonment in stages.

14. This view can also be supported by the change that was made regarding dividend payments by foreign operations (see paragraph 20 of this paper). Dividend payments by foreign operations (both pre-acquisition profits and post) can no longer be treated as a disposal or partial disposal and do therefore not result in any recycling of CTA. With reference to this change it can therefore be argued that part realisation without a change in relative ownership is not sufficient to trigger recycling. However, the amendment was made in relation to separate financial statements only, where the cost method is applied, so it is not clear whether this applies also to consolidated financial statements.

View 2 – Recycle CTA when absolute reduction

15. View 2 supports that amounts recognised in CTA related to a foreign operation are recycled any time there is a reduction in the entity's absolute ownership interest in the foreign operation.

16. This view closely follows the wording in paragraph 48D of IAS 21 in that '<u>any reduction</u> in an entity's ownership interest in a foreign operation' (emphasis added) is deemed to be a partial disposal. Based on the guidance in paragraph 48C for partial disposals of subsidiaries, 'the the entity shall re-attribute the proportionate share' of the CTA recognised in other comprehensive income

(OCI) to the non-controlling interests. Based on the guidance in paragraph 48C for any other partial disposal [of joint ventures or associates], 'the entity shall reclassify to profit or loss only the proportionate share' of CTA recognised in OCI.

17. CTA can be broadly seen as representing the 'unrealised gains/ losses' related to changes in foreign exchange rates that a parent/ investor has with respect to its net investment in the subsidiary/ joint venture/ associate. As long as that net investment remains in the foreign currency in any form (property, plant and equipment, financial assets, cash, etc.) the parent/ investor remains subjected to the changes in foreign exchange rates and no recycling of CTA should occur.

18. The rationale of CTA representing the unrealised gains/ losses is consistent with view 2. In the event of repatriating/ repaying a portion of the parent's/ investor's original investment that proportionate share of CTA is being 'locked in' at the foreign exchange rate at that date. That is, that portion of the CTA gain/ loss is 'realised' when the parent/ investor receives that value in the parent's / investor's functional currency. The parent/ investor is no longer subjected to changes in foreign exchange rates (for the portion of its original investment that was repatriated) and a proportional part of the CTA should be recycled.

19. Additionally, the advocates for view 2 say that using only changes in the proportionate ownership to decide when to recycle CTA (view 1) seems to give an odd result in the case of a liquidation or abandonment in stages, in that nothing is recycled until the very last bit is liquidated/ abandoned, at which time control/ significant influence/ joint control is lost through having no ownership interest.

Interaction with prior decisions

20. The staff believes the issues underlying this submission interact with other recent changes to paragraph 49 of IAS 21. As a result of the Board's decision to delete the requirement in IAS 27 to distinguish dividends paid out of pre-acquisition earnings from dividends paid out of post acquisition earnings, the

Board included a consequential amendment to IAS 21 to preclude reclassification of CTA from other comprehensive income into the statement of comprehensive income for all dividend payments. This consequential amendment is included in the *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to IFRS 1 and IAS 27) issued May 2008. The effects of the above change were discussed in paragraph 14 of this paper and seem to support view 1, however as already stated, the amendment was made in relation to separate financial statements only, where the cost method is applied, so it is not clear whether it applies also to consolidated financial statements.

21. In May 2009 the IFRIC considered an issue regarding the potential effect of IFRS 3 *Business Combinations* (as revised in 2008) and IAS 27 (as amended in 2008) on equity method accounting. IFRIC especially considered two issues:

    (a) how the initial carrying value of an equity method investment should be determined; and

    (b) how an equity method investee's issue of shares should be accounted for.

22. IFRIC noted that paragraph 19A of IAS 28 provides guidance on the accounting for amounts recognised in other comprehensive income when the investor's ownership interest is reduced, but the entity retains significant influence. It also noted that there is no specific guidance on the recognition of a gain or loss resulting from a reduction in the investor's ownership interest resulting from the issue of shares by the associate. However, it also noted that reclassification of amounts to profit or loss from other comprehensive income is generally required as part of determining the gain or loss on a disposal. Paragraph 19A of IAS 28 applies to all reductions in the investor's ownership interest, no matter the cause. IFRIC decided not to add this issue to its agenda.

23. The staff believes that the above arguments is consistent with view 1 as recycling of CTA could occur without any absolute reduction in ownership, only proportionate. However, this argument would probably only relate to net assets

of an associate accounted for under the equity method and it therefore remains unclear whether this would apply to net assets of consolidated subsidiaries.

Committee agenda criteria assessment

24. The staff's assessment of the Committee agenda criteria is as follows:

(a) *Is the issue widespread and practical?*

Yes. Transactions involving ownership in foreign operations are very common.

(b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*

No. The staff is not aware of significantly divergent interpretations in emerging or current practice. However, the effective date for the changes to IAS 21 that added paragraphs 48A-48D and amended paragraph 49 is for periods beginning on or after July 1, 2009.

(c) *Would financial reporting be improved through elimination of the diversity?*

Not applicable, as divergent interpretations do not appear to be emerging or currently exist in practice.

(d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*

Yes. In the staff's opinion, this issue is sufficiently narrow in scope to be capable of interpretation by the Committee.

(e) *It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis?*

Yes. This is a very narrow issue and it should be probable that the Committee would be able to reach a consensus on whether to clarify when repayment of investment in foreign operations should prompt recycling of CTA. However, based on previous discussions, it seems that there are different views among Committee members on this issue, which might prevent it from reaching consensus on a timely basis.

(f) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project?*

Yes. This issue could be impacted by ED 9 *Joint arrangements*. The Board is still the process of finalising the new standard. However, the staff do not believe the project intends to address this specific issue, on when to recycle CTA.

Assessment against *Annual Improvements* criteria

Assessment against currently used criteria

25. The existing criteria for inclusion in the 2009-2011 *Annual Improvements* cycle are that the change is non-urgent and necessary.

26. The staff believes the proposed clarification of the requirements to recycle CTA in paragraph 48D of IAS 21 meets these criteria in that it does not propose to introduce a new accounting principle. In addition, the proposed change enhances the quality of financial information.

Proposed new criteria

27. The Trustees have asked the Board to present enhanced criteria in determining the scope for the *Annual Improvements* process. This request is in response to comments received from constituents regarding appropriateness of criteria for judging whether an issue is an *Annual Improvement*.

28. At this stage, given the proposed new criteria are still to be finalised, the staff assesses inclusion in 2009-2011 *Annual Improvements* cycle with regards to the current criteria only. The staff will update the assessment accordingly prior to the publication of the exposure draft.

29. The staff recommends the change proposed in paragraph 48D be included in the 2009-2011 *Annual Improvements* cycle.

Staff recommendation

30. Based on the assessment of both the agenda criteria and the Annual Improvements Criteria, the staff recommend that this issue be added to Annual Improvements. In the staff's opinion the different interpretation of the requirements can lead to diversity in practice.

31. The staff is of the opinion that the clarification of the issue should be based on view 2, that is absolute reduction, as it find the arguments for doing so more compelling. The staff think that CTA represents the unrealised gains/ losses on translation adjustments relating to the investment. In the event of repatriating/ repaying a portion of the parent's/ investor's original investment that proportionate share of CTA is being 'locked in' at the foreign exchange rate at that date. That is, that portion of the CTA gain/ loss is 'realised' when the parent/ investor receives that value in the parent's / investor's functional currency. The parent/ investor is therefore no longer subjected to changes in foreign exchange rates (for the portion of its original investment that was repatriated)and proportional part of the CTA should be recycled

32. The staff is of the opinion that to extent the entity has additional investments in the foreign operation, other than equity, for example loans between the parent/ investor and the net investment (ie subsidiary/ joint venture/ associate), the reporting entity will be required to separately track and separately account for any foreign currency effects related to those additional 'investments'.

33. The proposed wording of the amendment is set out in Appendix B.

Questions for the Committee

34. The staff request the Committee answer the following questions:

Questions for the Committee
1. Does the Committee agree with the staff's recommendation to recommend the Board to add this issue to *Annual Improvements*?

2. Does the Committee agree with the proposed amendment as set out in Appendix B?
   If not, what wording would the Committee suggest?

3. Does the Committee have any comments on the proposed wording for the tentative decision in Appendix A?

Appendix A – Proposed tentative agenda decision wording

A1. The Staff proposes the following wording for the **tentative** decision.

> **IAS 21 *The Effects of Changes in Foreign Exchange Rates* — Repayments of investments/CTA**
>
> The Committee received a request for guidance on the recycling of CTA when a repayment of foreign investment occurs.
>
> The Committee noted that paragraph 48D of IAS 21 requires that an entity treats 'any reduction in an entity's ownership interest in a foreign operation' as a partial exposal, apart from those reductions in paragraph 48A that are accounted for as disposals.
>
> How an entity applies the disclosure requirements in paragraph 48D is largely dependent on how it interprets 'any reduction in an entity's ownership interest in a foreign operation.'
>
> The Committee does expect that different interpretations could lead to diversity in practice in the application of the guidance on the recycling of CTA when repayment of investment in foreign operation occurs. Therefore, the Committee [decided] to recommend the Board to address this issue through Annual Improvements.

Appendix B – Drafting of the proposed amendment

A1. This appendix includes proposed drafting of the proposed amendment. It is based on the text included in the Bound Volume as of 1 January 2010. New text is underlined.

Proposed amendment to IAS21 *The Effects of Changes in Foreign Exchange Rates*

Paragraph 48D is amended and paragraph 60D is added.

48D A partial disposal of an entity's interest in a foreign operation is any <u>absolute</u> reduction in an entity's ownership interest in a foreign operation, except those reductions in paragraph 48A that are accounted for as disposals.

Effective date

<u>60D *Improvements to IFRSs* issued in [date] amended paragraph 48D. An entity shall apply this amendment for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.</u>

Basis for Conclusions on proposed amendment to IAS 21 *The Effects of Changes in Foreign Exchange Rates*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Recycling of cumulative translation adjustments (CTA)

BC1 Concerns were raised that it was not clear in what situation cumulative translation adjustments (CTA) relating to net investments in foreign operations should be reclassified. Constituents argued that the requirements regarding disposal and partial disposals could be interpreted to say that either proportional reduction or absolute reduction in the net investment should result in CTA being recycled. Therefore the Board decided to clarify that recycling of CTA should occur when any absolute reduction in the net investment occurs.

Appendix C – Original Submission

A2. The original submission received by the staff has been included below without modification (except for removal of submitter contact information).

When should CTA be recycled under IAS 21 (revised) as amended by IAS 27R?

Consider the following case that involves a parent (P) and its net investment (NI).

P owns 100% of NI and controls it. NI liquidates 50% of its assets and pays the cash to P (eg by repaying a quasi equity loan from P or repurchasing share capital). After the transaction, P continues to own 100% of NI and continues to control it.

The issue is whether the separate foreign currency equity reserve related to the retranslation of the net assets of NI (often referred to as 'CTA') should be recycled in the above case. There appear to be two views:

View A: CTA should **not** be recycled. Since P continues to have 100% of NI, there has been no change in its 'ownership interest' and hence no disposal or partial disposal under IAS 21 paras 48D and 49. Under this view, 'ownership interest' refers to the percentage interest held and hence a partial disposal under para 49 can only arise for an associate or joint venture (see case 3 above), but never for a subsidiary. Those who support this view believe it is consistent with IAS 27 (revised) under which a gain or loss on disposal arises only when a parent loses control and not if its ownership interest is reduced (in either percentage or absolute terms) without a loss of control. This view is also consistent with the recent amendment to IAS 21 which removed a distinction between pre-acquisition and post-acquisition dividends (ie the payment of pre-acquisition dividend is not considered a partial disposal of a net investment).

View B: A pro rata share (ie 50%) of CTA should be recycled. The transaction is a partial disposal per IAS 21.49 as there has been a reduction in P's ownership interest. Under this view' ownership interest' refers to both the percentage and the absolute interest held in a net investment, and hence a partial disposal under para 49 can arise for all of a subsidiary, associate or joint venture. Those who support this view point out that para 49 was not amended by IAS 27, and believe the above situation is different to the specific situations added to the standard by IAS 27 that deal only with transactions between a parent and a minority. Furthermore, view A seems to give an odd result in the case of a liquidation or abandonment in stages, in that nothing is recycled until the very last bit is liquidated/ abandoned, at which time control is lost through having no ownership interest.

This issue arises for all transactions in which there is a reduction in the amount of a net investment in a subsidiary, but no percentage change in the ownership interest and no loss of control. The only exception would be payments of dividends that do not amount to a liquidation or partial liquidation, which now do not result in recycling whether they are from pre- or post-acquisition profits (amendment to IAS 21.49 from the IAS 27 and IFRS 1 amendments).

Excerpts from IAS 21 - Disposal or partial disposal of a foreign operation

48. On the disposal of a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation recognised in other comprehensive income and accumulated in the separate component of equity shall be reclassified from equity to profit or loss (as a reclassification adjustment) when the gain or loss on disposal is recognised (see IAS 1 *Presentation of Financial Statements* (as revised in 2007)).

48A 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.

48B On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be derecognised, but shall not be reclassified to profit or loss.

48C On the partial disposal of a subsidiary that includes a foreign operation, the entity shall re-attribute the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income to the non-controlling interests in that foreign operation. In any other partial disposal of a foreign operation the entity shall reclassify to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognised in other comprehensive income.

48D A partial disposal of an entity's interest in a foreign operation is any reduction in an entity's ownership interest in a foreign operation, except those reductions in paragraph 48A that are accounted for as disposals.

49 An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity. A write-down of the carrying amount of a foreign operation, either because of its own losses or because of an impairment recognised by the investor, does not constitute a partial disposal. Accordingly, no part of the foreign exchange gain or loss recognised in other comprehensive income is reclassified to profit or loss at the time of a write-down.

Appendix D – Proposed consequential amendments to IAS 21 which may result from the issuance of IFRS X *Joint Arrangements*.

A3. Following is the proposed new text of paragraph 48A of IAS 21 which will be changing with the issuance of the new IFRS on Joint Arrangements.

48A In addition to the disposal of an entity's entire interest in a foreign operation, the following partial disposals are accounted for as disposals:

(a) when the partial disposal involves the loss of control of subsidiary that includes a foreign operations, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the partial disposal.

(b) when the retained interest after the partial disposal of an interest in a joint arrangement or a partial disposal of an interest in an associate that includes a foreign operation is a financial asset that includes foreign operation.