IFRS

STAFF PAPER

September 2018

IFRS® Interpretations Committee meeting

Project	**IAS 27 *Separate Financial Statements*––Investment in a subsidiary accounted for at cost: Partial disposal**		
Paper topic	Initial consideration		
CONTACT(S)	Vincent Louis	vlouis@ifrs.org	+44 (0) 20 7246 6470
	Jawaid Dossani	jdossani@ifrs.org	+44 (0)20 7332 2742

Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the application of IAS 27 *Separate Financial Statements* when an entity disposes of part of its interest in a subsidiary and loses control of that subsidiary.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter and our research and analysis; and

   (b) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information;

   (b) summary of outreach;

   (c) staff analysis;

   (d) staff recommendation; and

(e) questions for the Committee.

4. There are two appendices to this paper:

   (a) Appendix A—proposed wording of the tentative agenda decision; and

   (b) Appendix B—submission.

Background information

5. Paragraph 10 of IAS 27 requires an entity that prepares separate financial statements to account for investments in subsidiaries, joint ventures and associates either:

   (a) at cost;

   (b) in accordance with IFRS 9 *Financial Instruments;* or

   (c) using the equity method as described in IAS 28 *Investments in Associates and Joint Ventures*.

6. In the fact pattern described in the submission, Entity A:

   (a) prepares separate financial statements applying IAS 27;

   (b) holds an equity interest in Entity B and controls Entity B—ie Entity B is a subsidiary of Entity A. Applying paragraph 10 of IAS 27, Entity A elects to measure its investment in Entity B at cost; and

   (c) subsequently disposes of part of its interest in Entity B and loses control of Entity B (partial disposal transaction). After the partial disposal transaction, Entity A does not have joint control of, or significant influence over, Entity B. The retained interest is an equity instrument as defined in paragraph 11 of IAS 32 *Financial Instruments: Presentation*. Entity A applies IFRS 9 in accounting for its retained interest in Entity B (retained interest) and measures that retained interest at fair value.

7. The submitter asks whether Entity A:

   (a) can apply the election in paragraph 4.1.4 of IFRS 9 to present subsequent changes in fair value of the retained interest in other comprehensive income (OCI) rather than in profit or loss (Question A); and

(b) presents in profit or loss or OCI any difference between the cost and fair value of its retained interest on the date it loses control of Entity B (Question B).

8. The submitter's questions relate only to separate financial statements and not to consolidated financial statements. Appendix B to this paper reproduces the submission and provides further details about the accounting approaches identified by the submitter.

Summary of outreach

9. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators and the large accounting firms.

10. In our request we asked whether, in the participants' experience, the partial disposal transaction is common.

11. We received thirteen responses—five from the large accounting firms, four from national standard-setters, two from regulators, one from an organisation representing groups of regulators and one from a Committee member. The views received represent informal opinions and do not represent the official views of those respondents.

Findings

12. Respondents indicated that the prevalence of the partial disposal transaction depends on whether entities:

(a) are required or permitted to prepare separate financial statements;

(b) apply IFRS Standards in preparing those separate financial statements; and

(c) elect or are required (because of jurisdictional regulations) to measure investments in subsidiaries at cost in those separate financial statements.

13. Four respondents said they had no experience of this transaction and two respondents said their experience is limited. This is because entities in their jurisdictions are either

not required to prepare separate financial statements or do not apply IFRS Standards to separate financial statements.

14. Five respondents said the partial disposal transaction occurred more than infrequently in some jurisdictions. Two respondents said partial disposal transactions were not common.

Staff analysis

Question A: can Entity A elect to present subsequent changes in fair value of the retained interest in OCI?

15. In analysing this question, we first considered which IFRS Standard Entity A applies to the retained interest and then considered how Entity A applies those requirements.

Which IFRS Standard applies to the retained interest?

16. Paragraph 9 of IAS 27 states that 'separate financial statements shall be prepared in accordance with all applicable IFRSs, except as provided in paragraph 10'. Paragraph 10 of IAS 27 requires an entity that prepares separate financial statements to account for investments in subsidiaries, joint ventures and associates either (i) at cost, (ii) in accordance with IFRS 9, or (iii) using the equity method as described in IAS 28.

17. In the fact pattern described in the submission, Entity A elects to account for its investment in subsidiaries at cost in its separate financial statements. As a result of the partial disposal transaction, Entity A loses control of Entity B. In addition, Entity A does not have joint control of, or significant influence over, Entity B. Consequently, after the partial disposal transaction, Entity B is not a subsidiary, joint venture or associate of Entity A—and the requirements in paragraph 10 of IAS 27 are not applicable. Accordingly, Entity A applies the requirements in other IFRS Standards in accounting for its retained interest. The retained interest is an investment in an equity instrument as defined in paragraph 11 of IAS 32—ie a

financial instrument. Therefore, Entity A applies IFRS 9 in accounting for the retained interest[1].

Applying the requirements in IFRS 9

18. Paragraph 4.1.4 of IFRS 9 states (emphasis added):

> *A financial asset shall be measured at fair value through profit or loss* unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A...

19. Investments in equity instruments do not meet the conditions in paragraphs 4.1.2 or 4.1.2A of IFRS 9 and, accordingly, are measured at fair value. This is because such instruments do not have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Paragraph B5.2.3 of IFRS 9 confirms this, stating that an entity must measure all investments in equity instruments and contracts on those instruments at fair value. Applying these requirements, Entity A measures its retained interest at fair value.

20. Paragraph 4.1.4 of IFRS 9 also states (emphasis added):

> …However an entity may make an irrevocable election *at initial recognition* for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to *present subsequent changes in fair value in other comprehensive income* (see paragraphs 5.7.5–5.7.6).

21. Paragraph 5.7.5 of IFRS 9 further specifies that at initial recognition, an entity may apply this presentation election only to an investment in an equity instrument within the scope of IFRS 9 that is neither held for trading (as defined in Appendix A of IFRS 9) nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies.

22. We think 'at initial recognition' in paragraph 4.1.4 of IFRS 9 refers to the date on which Entity A begins to apply the requirements in IFRS 9 to its retained interest

[1] We assume in this paper that the financial instrument is not subject to any of the scope exceptions set out in paragraph 2.1 of IFRS 9.

(ie the date on which it loses control of Entity B). It does not refer to the date it originally acquired the interest in Entity B. The requirements in paragraph 22 of IAS 28 *Investments in Associates and Joint Ventures* on discontinuing the use of the equity method supports our view. This paragraph states that an entity discontinues the use of the equity method when its investment ceases to be an associate or joint venture. Paragraph 22(b) of IAS 28 states that if the retained interest in the former associate or joint venture is a financial asset, the entity measures the retained interest at fair value and this fair value is regarded as its fair value on *initial recognition as a financial asset in accordance with IFRS 9.*

23. Applying these requirements, we think Entity A may elect to present subsequent changes in fair value of its retained interest in OCI if the retained interest is not held for trading. Entity A would make this irrevocable election on the date that it starts applying the requirements in IFRS 9 to its retained interest.

Question B: how does Entity A account for any difference between the cost and fair value of its retained interest on the date that it loses control?

24. Paragraph 5.1.1 of IFRS 9 requires an entity to measure a financial asset at fair value at initial recognition[2]. The submitter asked whether Entity A presents in profit or loss or OCI any difference between the cost and fair value of its retained interest, and whether this conclusion would differ if Entity A elects to present in OCI (rather than in profit or loss) subsequent changes in fair value of its retained interest.

25. IAS 27 does not explicitly specify how an entity accounts for any difference between the cost and fair value of its retained interest on the date it loses control. In applying paragraphs 10-11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (which apply when IFRS Standards do not specifically apply to a transaction), we first considered whether there are requirements in IFRS Standards dealing with similar and related issues.

26. As explained in paragraph 22 of this paper, IAS 28 specifies how an entity accounts for a transaction that results in discontinuing the use of the equity method (because

[2] Except for trade receivables within the scope of paragraph 5.1.3 of IFRS 9, which are not relevant to this discussion.

the investment ceases to be an associate or joint venture) but retaining an interest in the former associate or joint venture that is a financial asset. Paragraph 22(b) of IAS 28 specifies that, in this situation, the entity recognises in profit or loss any difference between (i) the fair value of the retained interest and any proceeds from disposing of a part interest in the associate or joint venture; and (ii) the carrying amount of the investment at the date the equity method is discontinued. This applies regardless of whether the entity elects to present in OCI subsequent changes in fair value of the retained interest.

27. Paragraph 11A of IAS 27 requires an investment entity to measure investments in particular subsidiaries at fair value through profit or loss applying IFRS 9—the investment entity cannot elect to measure its investments in subsidiaries at cost or using the equity method. Similar to the partial disposal transaction, an entity that becomes an investment entity no longer measures its investments in subsidiaries at cost (or using the equity method). Paragraph 11B(b) of IAS 27 requires an entity that becomes an investment entity to recognise in profit or loss any difference between the previous carrying amount and fair value of its subsidiaries at the date it becomes an investment entity.

28. Based on our analysis of the requirements in IFRS Standards for similar and related issues, we think Entity A presents in profit or loss any difference between the cost and fair value of its retained interest.

29. The submitter says some hold the view that Entity A would present any difference in OCI if it has elected to present in OCI subsequent changes in fair value of its retained interest. We do not agree—this is because:

    (a) paragraph 4.1.4 of IFRS 9 (reproduced in paragraph 20 of this paper) specifies that the presentation election applies to ‘subsequent changes’ in fair value of an investment in an equity instrument—ie the changes in fair value that arise after initial recognition. Any difference between the cost and fair value of the retained interest at the date that the entity loses control does not arise after initial recognition of the retained interest applying IFRS 9. This is consistent with the overall approach in IFRS 9, which requires an entity to measure financial instruments at fair value on initial recognition and then separately addresses the accounting for subsequent changes in fair value.

(b) this difference does not result from a change in fair value but instead results from a change in the measurement basis of the retained interest when an entity loses control of an investee. Accordingly, this difference is not a subsequent change in the fair value of the equity instrument and, thus, an entity does not present it in OCI applying the presentation election in paragraph 4.1.4 of IFRS 9.

30. In addition, based on our discussion in paragraphs 59–64 of Agenda Paper 6B for this meeting, we think the difference (that results from a change in measurement basis of the retained interest due to a transaction—ie loss of control) meets the definition of income or expenses in the 2018 *Conceptual Framework for Financial Reporting*. As explained in paragraphs 65–67 of Agenda Paper 6B, an entity recognises this income or expense in profit or loss.

31. Based on our analysis, we think Entity A presents in profit or loss any difference between the cost and fair value of its retained interest at the date it loses control of Entity B.

Question 1 for the Committee
Does the Committee agree with our analysis in paragraphs 15–31 of this paper that, on the date it loses control of Entity B, Entity A: (i) accounts for its retained interest in Entity B applying IFRS 9; (ii) can elect to present in OCI subsequent changes in fair value of that retained interest if the retained interest is not held for trading; and (iii) recognises as income or expense, and presents in profit or loss, any difference between the cost and fair value of its retained interest.

Should the Committee add this matter to its standard-setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[3]

32. Based on our analysis, we think the requirements in IFRS Standards provide an adequate basis for an entity to account in its separate financial statements for a partial disposal transaction.

Staff recommendation

33. Having considered the agenda criteria in paragraphs 5.16-5.17 of the *Due Process Handbook*, we recommend that the Committee not add the matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that explains the requirements that an entity applies when accounting for the partial disposal transaction described in the submission.

34. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

[3] Paragraph 5.16(b) of the *Due Process Handbook*.

Appendix A—Proposed wording of the tentative agenda decision

The Committee received a request about how an entity applies the requirements in IAS 27 *Separate Financial Statements* to a fact pattern involving an investment in a subsidiary.

In the fact pattern described in the request, the entity preparing separate financial statements:

- elects to account for its investments in subsidiaries at cost applying paragraph 10 of IAS 27.
- holds an initial investment in a subsidiary (investee). The investment is an investment in an equity instrument as defined in paragraph 11 of IAS 32 *Financial Instruments: Presentation*.
- subsequently disposes of part of its investment and loses control of the investee. After the disposal, the entity has neither joint control of, nor significant influence over, the investee.

The request asked whether:

(a) the investment retained (retained interest) is eligible for the presentation election in paragraph 4.1.4 of IFRS 9 *Financial Instruments*. That election permits the holder of particular investments in equity instruments to present subsequent changes in fair value in other comprehensive income (OCI) (Question A).

(b) the entity presents in profit or loss or OCI any difference between the cost of the retained interest and its fair value on the date of losing control of the investee (Question B).

Question A

Paragraph 9 of IAS 27 requires an entity to apply all applicable IFRS Standards in its separate financial statements, except when accounting for investments in subsidiaries, associates and joint venture. After the partial disposal transaction, the investee is not a subsidiary, associate or joint venture of the entity. Accordingly, the entity applies IFRS 9 in accounting for its retained interest in the investee. The Committee observed that the presentation election in paragraph 4.1.4 of IFRS 9 applies at initial recognition of an investment in an equity instrument. An investment in an equity instrument within the scope of IFRS 9 is eligible for the election if it is neither held for trading (as defined in Appendix A of IFRS 9) nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies.

In the fact pattern described in the request, assuming the retained interest is not held for trading, the Committee concluded that (i) the retained interest is eligible for the presentation election in paragraph 4.1.4 of IFRS 9, and (ii) the entity would make this presentation election when it first applies IFRS 9 to the retained interest (ie at the date of losing control of the investee).

Question B

IAS 27 does not explicitly specify how, in its separate financial statements, an entity recognises any difference between the cost of the retained interest and its fair value on the date of losing control of a subsidiary. In these circumstances, the entity applies the requirements in paragraphs 10-11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and considers if there are requirements in other IFRS Standards dealing with similar and related issues. The Committee observed that paragraph 22(b) of IAS *28 Investments in Associates and Joint Ventures* and paragraph 11B of IAS 27 deal with similar and related issues. Based on its analysis of those requirements, the Committee concluded that the entity recognises this difference in profit or loss.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to account for a partial disposal transaction in its separate financial statements.

Consequently, the Committee [decided] not to add the matter to its standard-setting agenda.

Appendix B—Submission

We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

Accounting treatments for step disposal or step acquisition of interests in a subsidiary in the separate financial statements of a parent

For ease of reference, we provide simplified illustrative examples as follows.

[…] Accounting treatment for losing control by step disposal of interests in a subsidiary in the separate financial statements

Background information

- P Co. (parent) accounts for its investments in S Co. (subsidiary) at cost in its separate financial statements (Paragraph 10 in IAS 27)
- (Dec. 31, 20X0) P Co. is holding 55% of the equity in S Co. and has control of S Co.
- (Jan. 31, 20X1) P Co. disposes of 45% of the equity in S Co. and loses control.
- In its separate F/S, P Co. decides to make an irrevocable election for the retained interests (10%) in S Co. to present subsequent changes in fair value in OCI. (Paragraph 5.7.5 in IFRS 9)

Issues

1. Can P Co. make an irrevocable election to measure the investment (10%) at FVOCI?

2. If P Co. decides to use the FV-OCI election for the retained interests (10%) in S Co. at the date of losing control, how should the difference between the carrying amount of the retained interests and fair value of the retained interests be accounted for in its separate financial statements?

Views

View 1: a difference between the carrying amount of the retained interests and fair value of the retained interests shall be recognized as OCI in P Co' separate financial statements

3. If the irrevocable election is applied to present in OCI the changes in the fair value of the retained interests in S Co., the gain or loss recognised in OCI shall not be subsequently transferred to profit or loss.

4. Considering the objective of prohibiting reclassification from equity to profit or loss for the cumulative OCI under IFRS 9, the difference between the carrying amount of the retained interests and fair value of the retained interests shall not be recognized as profit or loss at the date of losing control.

View 2: a difference between the carrying amount of the retained interests and fair value of the retained interests shall be recognized as profit or loss in P Co' separate financial statements.

5. By losing control, IFRS 9 is newly applied to the retained interests in S Co. and the new financial asset is recognised at fair value at the date of losing control according to IFRS 9. It means that the previous total interests in S Co. were disposed at fair value and P Co. purchased an entirely new financial asset.

6. Therefore, the difference between the carrying amount of the retained interests and fair value of the retained interests shall be recognized as profit or loss.

…

<u>Reasons for the IFRS IC to address the issue</u>

(a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

Yes. As there is no specific guidance on the issue addressed in this paper under IAS 27 and IFRS 9, different views exist on the accounting treatments for step disposal or step acquisition of interests in a subsidiary. Major accounting firms also seem to hold different views on this issue – please refer to the below details pertaining to the Big 4 global manual, in the alphabetical order.

i. Deloitte, iGAAP 2017 […].

ii. EY, International GAAP 2016 […].

iii. KPMG, 13th Edition 2016/17 […].

(b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes. Consistent application of IFRS Standards on the issue would enhance comparability of financial statements across entities.

(c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

Yes. It can be resolved efficiently as the issue is related to the interpretation of paragraph 10 of IAS 27 when applying IFRS 9.

(d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?

Yes. We specified the issue to be the accounting treatments for partial disposal or partial acquisition of interests in a subsidiary.

(e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period?

Yes. The issue does not relate to any of current or planned IASB projects.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee’s agenda.