IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IFRS 11 *Joint Arrangements***		
Paper topic	Remeasurement of previously held interests—Loss of control transaction		
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Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify whether a previously held interest in the assets and liabilities of a joint operation should be remeasured to fair value when an investor's acquisition of an additional interest results in the investor becoming a joint operator (ie assuming joint control) of the investee.

2. As part of its analysis of this issue, the Interpretations Committee observed that it would be useful to analyse other transactions involving previously held interests in which there are different views on whether such interests should be remeasured or not. At its meeting in July 2015, the Interpretations Committee agreed that the scope of the project should, initially, include transactions involving:

   (a) obtaining control of a joint operation, either from having joint control in, or being a party to, a joint operation prior to the transaction;

   (b) loss of control resulting in the entity having joint control in, or being a party to, a joint operation subsequent to the transaction (hereafter referred to as a 'loss of control transaction'); and

   (c) change of interests resulting in a party to a joint operation obtaining joint control in a joint operation.

3. Agenda Paper 05 of this meeting (hereafter referred to as 'the Covering Memo') provides an overview and an analysis of the existing guidance in relation to the measurement of previously held interests. It also identifies some guiding principles that we think can be used in performing the analysis of the specific transactions noted in paragraph 2.

4. The objective of this agenda paper is to provide the Interpretations Committee with our analysis and recommendation on the transaction described in paragraph 2(b) (ie a loss of control transaction). The analysis draws on the general principles developed in the Covering Memo.

5. This paper provides:

    (a) background information;

    (b) staff analysis; and

    (c) staff recommendation.

Background information

6. An entity may enter into a transaction by which it loses control of a business. The transaction might result in the entity having joint control of, or being a party to, a joint operation subsequent to the transaction. The question arises as to how the retained interest should be accounted for as a result of this loss of control transaction.

7. We understand from our outreach (see results of outreach in Agenda Paper 6 of the Interpretation Committee's meeting in July 2015), that there are three divergent views that are developing in practice:

    (a) View 1—the entity's retained interest is remeasured to fair value;

    (b) View 2—the entity's retained interest is not remeasured; and

    (c) View 3—the entity's retained interest is remeasured only if the business is structured through a separate legal entity.

8. While the issue has primarily arisen within the context of loss of control of a business (as defined in IFRS 3 *Business Combinations*), we will also analyse transactions involving assets, or groups of assets that do not meet the definition of a business later in this paper.

View 1—the retained interest is remeasured

9. Proponents of this view note that paragraph 25 of IFRS 10 provides guidance for accounting for a loss of control transaction and requires retained interests to be remeasured.

10. In particular paragraphs 25 and B98 of IFRS 10 require an entity to:

    (a) derecognise the assets and liabilities of the subsidiary;

    (b) recognise any investment retained in the former subsidiary at fair value at the date when control is lost; and

    (c) recognise any resulting gain or loss in profit or loss.

11. They also note that paragraph BCZ182 of IFRS 10 notes that in the IASB’s view loss of control is a significant economic event, which results in a change in the nature of the investment. This same rationale is also applicable to the transaction being discussed.

View 2—the retained interest is not remeasured

12. Proponents of this view think that paragraph 25 of IFRS 10 was only intended to address the scenario in which the retained interest will be subsequently accounted for as a financial asset or an investment in an associate or a joint venture and is not applicable to a loss of control transaction that results in the entity having joint control in, or being a party to, a joint operation subsequent to the transaction. They think that an entity should not derecognise or remeasure the share of assets and liabilities of the joint operation in which it retains an interest

13. They also note that paragraphs B34 and B35 of IFRS 11 contain specific guidance on accounting for sales or contributions of assets to a joint operation. In accordance with these requirements, gains and losses can only be recognised to the extent of the other parties' interests in the joint operation.

View 3—the retained interest should be remeasured only if the joint operation is structured through a separate legal entity

14. Proponents of this view note that the guidance in paragraph 25 of IFRS 10 applies only to loss of control of a subsidiary. Appendix A of IFRS 10 defines a subsidiary as an entity that is controlled by another entity. Accordingly, proponents of this view distinguish the accounting for loss of control depending on whether the business is housed in a separate legal entity or not.

    (a) If a business is housed in a separate legal entity the requirements in paragraph 25 of IFRS 10 would be applicable and any retained interests would be remeasured.

    (b) If the business is not housed in a separate legal entity, the guidance in paragraph 25 is not applicable and the retained interests are not required to be remeasured.

Staff analysis

Determining the appropriate accounting treatment for transactions involving businesses

15. This section presents our analysis of the appropriate accounting treatment for loss of control transactions that meet the definition of a business (as defined in IFRS 3 *Business Combinations*). In developing our analysis, we have drawn on the general principles identified in the Covering Memo.

16. As noted in the Covering Memo, we think:

(a) the significance of the underlying economic event should be the primary factor in assessing whether or not previously held interests should be remeasured. A change in the basis of accounting may indicate that a significant economic event has occurred and can be used as a factor to assess whether or not there has been a significant economic event;

(b) the measurement model (ie a cost model or a fair value model) applicable to the recognition of the previously held/retained interests should be considered;

(c) the accounting for previously held interests should be separately analysed for transactions involving assets or groups of asset that meet the definition of a business versus those that do not; and

(d) the use of a cost accumulation model should be avoided where this can be justified because users have criticised its use as resulting in information that lacks consistency, understandability and usefulness.

We do not think the structure of the investment, and whether or not the investment is housed in a separate legal entity, should affect the analysis.

Does the loss of control represent a significant economic event?

17. Paragraph BCZ182 of IFRS 10 explains that in the IASB's view:

> […] loss of control of a subsidiary is a significant economic event. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. Therefore, the new investor-investee relationship is recognised and measured initially at the date when control is lost.

18. We think that the loss of control transaction represents a significant economic event. This is because the entity has surrendered its controlling interests in exchange for being either a passive investor (ie a party to the joint operation) or a joint controller in the joint operation. In effect, it has surrendered its right to unilaterally *direct* how the

acquiree and its management use those assets in its operation. It no longer has *unilateral decision-making power* over the wealth generating abilities of the business. Even if the entity is a joint operator, it will now be required to co-ordinate its decision-making over the business and its assets and liabilities with other parties. Consistently with our analysis in the Covering Memo, we think that the loss of control transaction changes the nature of the investment and the relationship between the parties.

19. We think that the basis of accounting is a secondary factor in assessing whether or not there has been a significant economic event, but should not be a primary driver of the analysis.

20. In the case of the loss of control transaction, we think that the key factor in this analysis is that the investor has now lost unilateral control over the underlying assets and liabilities of the former joint operation and we do not think that the basis of accounting affects our view that the loss of control transaction represents a significant economic event.

What is the applicable measurement model that should be applied to the previously held interests?

21. Paragraph 21 of IFRS 11 notes that a joint operator shall account for the assets, liabilities, revenues and expenses relating to its interests in a joint operation in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses. Some of those standards, such as IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets,* provide a cost-based model for initial recognition.

22. IFRS 10 requires an entity to remeasure its retained interest to fair value when an entity loses control of a subsidiary (where the subsidiary meets the definition of a business). We note that IAS 28 *Investments in Associates and Joint Ventures* uses a cost-based model, because it specifies that an investment in an associate or a joint venture is recognised at cost on initial recognition (paragraph 10 of IAS 28).

Paragraph 25 (b) of IFRS 10 notes that the *remeasured value shall be regarded as the cost* on initial recognition of an investment in an associate or a joint venture.

23. We think that the fair value model used by IFRS 10 in accounting for loss of control in a subsidiary would also be applicable in the loss of control transaction and we think that this supports the view that the retained interests should be remeasured.

Does the structure of the joint operation affect the analysis of the appropriate accounting treatment?

24. Some constituents have noted the fact that the guidance in IFRS 10 is only applicable to a subsidiary, which is defined in Appendix A of IFRS 10 as an entity that is controlled by another entity. They question whether the guidance is applicable in instances where there is no separate legal entity in place (proponents of View 3).

25. As noted in our Covering Memo, we think the focus of the IASB in developing the guidance on loss of control in IFRS 10 was not on the structure of the investment, but on the substance of the underlying transaction.

26. We also note that the term 'entity' is not a defined term within IFRS. The recently published Exposure Draft *Conceptual Framework for Financial Reporting* notes that a 'reporting entity' is '*an entity* that chooses to, or is required, to present general purpose financial statements' (emphasis added). In accordance with this definition, it could be argued that all joint operations, however structured, are entities, because they could choose to (and in many cases, might be required to) prepare general purpose financial statements.

27. However, we do not think it is necessary for the Interpretations Committee to determine whether or not a joint operation is an entity in order to determine the appropriate treatment for the retained interests.

28. On the basis of the discussion above and our analysis of this issue in the Covering Memo, we do not think the structure of the joint operation should affect the analysis of the appropriate accounting treatment. We do not think that there should be a different accounting treatment for entities that are structured through a separate legal

entity versus those that are not, but we acknowledge that the wordings in the existing guidance can provide a technical basis for reaching that conclusion (ie, View 3).

Conclusion

29. On the basis of the analysis above, it is our view that the retained interests should be remeasured (ie View 1) with the resulting gain or loss being recognised in profit or loss in loss of control transactions involving a business. However, we acknowledge that the wording in paragraph 25 of IFRS 10 could provide a technical basis for reaching different conclusions, depending on whether or not the business is structured through a separate legal entity.

Determining the appropriate accounting treatment for transactions involving assets or groups of assets that do not meet the definition of a business

30. The IASB recently discussed a related issue of sale or contribution of assets to a joint venture or an associate, details of which are provided in the next section. We think the outcome of the IASB discussions has a direct impact on the analysis of this transaction.

31. We note that the fact patterns raised by constituents in the past on this issue relate to joint operations that constitute a business. On the basis of past experience and previous outreach, we do not think that similar transactions not involving a business are common in practice.

32. Consequently, we do not think the Interpretations Committee should include within the scope of this project loss of control transactions that do not meet the definition of a business.

Other considerations

33. The IASB noted a conflict between the requirement to eliminate gains and losses resulting from downstream transactions with associates and joint ventures in IAS 28 versus the requirement to recognise in full all gains and losses resulting from loss of

control of a subsidiary in instances in which the retained interest might be classified as an associate or a joint venture.

34. In order to address this conflict, the IASB recently made some amendments to IFRS 10 and IAS 28. The IASB noted that when the asset or a group of assets contributed meets the definition of a business, full gain or loss recognition is required and the retained interest should be measured at fair value. When the asset or group of assets contributed does not meet the definition of a business, only partial gain or loss recognition is permitted (to the extent of the unrelated investors' interests). Consequently, the amendment to IFRS 10 specifies that when an investment is retained in the former subsidiary (either an associate or a joint venture) that is not a business, the retained interest is still remeasured to fair value; however, the part of the gain or loss resulting from the remeasurement that does not relate to the unrelated investors' interests should be eliminated against the carrying amount of the retained investment. Where the retained interest is a financial asset, the retained interest would be measured at fair value and the gain or loss resulting from the remeasurement would be recognised in full in profit or loss.

35. This results in the retained investment being measured at a different amount post-transaction depending on whether or not the transaction involved a business, and on the nature of the retained investment. For example, in cases in which the transaction involved a business, or the retained interest was classified as a financial asset, the retained interest is measured at fair value. In cases in which the transaction did not involve a business and the retained interest is an equity-method accounted for investee, the carrying amount will be different as a result of the partial elimination of gains.

36. Subsequent to this amendment, the IASB intended to propose a further narrow-scope amendment to clarify some matters linked to this amendment. However, the IASB decided that those issues should instead be addressed as part of the limited-scope research project on the equity method of accounting. Accordingly, the IASB has

decided to postpone these amendments until this project is completed, in order to avoid making multiple changes to the Standard within a short period of time.

37. A similar conflict exists for joint operations. Paragraphs B34 and B35 of IFRS 11 contain specific guidance on accounting for sales or contributions of assets to a joint operation. In accordance with these requirements, gains and losses can only be recognised to the extent of the other parties’ interests in the joint operation. The wording in these paragraphs could be seen as conflicting with the requirements in IFRS 10 to remeasure any retained interest.

38. Because of the similarities of the existing conflicts, we think that any guidance that the Interpretations Committee develops for the loss of control transactions should be consistent with, and be informed by, the decisions taken in the limited-scope research project on the equity method of accounting. We recommend that the Interpretations Committee should defer further discussions on this transaction until the research project has been completed and the IASB has made a decision on its recent amendments.

Staff recommendation

39. On the basis of our analysis we think that the Interpretations Committee should defer further discussions on loss of control transactions involving a business until the limited-scope research project on the equity method of accounting has been completed and the IASB has made a decision on its recent amendments.

40. We think that a loss of control transaction not involving a business that result in the entity having joint control in, or being a party to, a joint operation subsequent to the transaction are not common and should not be included within the scope of this project.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with our analysis in this paper and our conclusion that, in loss of control transactions that meet the definition of a business, retained interests should be remeasured?

2. Does the Interpretations Committee agree with our conclusion that the Interpretations Committee should defer providing guidance on the loss of control transaction involving a business until the limited-scope research project on the equity method of accounting has been completed?

3. Does the Interpretations Committee agree with our conclusion that a loss of control transaction not involving a business that results in the entity having joint control in, or being a party to, a joint operation subsequent to the transaction should not be included within the scope of the project?