

**IFRS IC**  
**Wayne Upton**

**Cannon Street 30**  
**London EC4M 6XH**  
**United Kingdom**

## **Agenda item request: Discontinued operations - Change in disposal method**

Dear Mr Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

As a result of the review of the financial statements carried out by national competent authorities and ESMA's co-ordination activities, we have identified an issue related to the application of IFRS 5 – *Non-current Assets Held for Sale and Discontinued Operations*, which we would like to bring to the attention of the IFRS Interpretations Committee for further consideration.

A detailed description of the case is set out in the appendix to this letter.

We would be happy to further discuss this issue with you.

Yours sincerely,



Steven Maijor  
Chair  
ESMA



Julie Galbo  
Chair  
ESMA's Corporate Reporting Standing Committee

## **APPENDIX – DETAILED DESCRIPTION OF THE ISSUE**

1. Enforcers have identified divergent practices regarding the impact of a change in disposal method on the classification of assets held for sale in accordance with IFRS 5, as illustrated in the example below.

### **Description of the issue**

2. Entity A has a December fiscal yearend and prepares its annual consolidated financial statements in accordance with IFRS.
3. On 30 June 20X1 Entity A's Board of Directors approved a plan to dispose of its profitable Division B by way of an initial public offering (IPO) planned to be completed by the end of the January 20X2. Entity A initiated internal IPO preparations for the sale of Division B including the preparation of regulatory and sales documents and engaging external advisors. In preparing for the IPO the business activities of Division B were separated into a distinct legal entity. Entity A did not file documents with its regulators, yet management communicated regularly its plans to the public. It believed that approval of the prospectus was highly probable. It determined internal price ranges but has not publicly announced an offering price. Various third-party analysts commented on their estimated market value of Division B. Entity A classified Division B as a discontinued operation in its interim financial statements as of 30 June 20X1 with consequential changes to the presentation of the statement of comprehensive income. Entity A classified the disposal group's net assets as held for sale and discontinued depreciating Division B's non-current assets.
4. During the second half of 20X1 market conditions declined. As of 31 December, 20X1 Entity A determined that the disposal of Division B by way of an IPO was no longer feasible as initially scheduled. The IPO was still intended to be completed within 12 months of the original classification as discontinued operations. As of 31 December 20X1 Entity A re-evaluated the criteria in IFRS 5 and continued to classify Division B as a discontinued operation. It asserted that it was still committed to the disposal of Division B through an IPO during the first half of 20X2. Entity A also asserted that it believed that market conditions would improve and enable Entity A to sell Division B by way of an IPO. Entity A continued to update its documents to be filed with its securities regulator, meet weekly with its outside advisors, and monitored market conditions. It has not filed any offering documents with its securities regulator. Although Entity A was not permitted by law to contact prospective non-institutional buyers until after it receives regulatory approval, it may contact institutional buyers. It has re-evaluated internal price ranges and has still not announced an offering price publicly.
5. On June 30 20X2, one year after the original designation of Division B as held for sale, Entity A again reassesses the market and confirms its intention to dispose of Division B; however, management has now decided that an IPO was less likely. Instead, Division B will be spun off and distribut-

ed to its shareholders by means of a dividend-in-kind. The Division B shares would then be listed separately on the stock exchange. Thus, both alternatives will be pursued.

6. Since a spin-off to shareholders is now also being considered, Entity A treats the classification of discontinued operations as a change to the plan of sale (IFRS 5, paragraph 26) and in the second half of 20X2 recognizes any depreciation, amortisation or revaluations that would have been recognised had the disposal group not been classified as held for sale. Nevertheless, the classification of the disposal group as discontinued operations (or “held for distribution to owners”) remains since the spin off (or IPO) is expected to be complete within the next 12 months (IFRS 5 paragraph 12).

### **Discussion**

7. This issue is divided into two parts corresponding to the two year-end balance sheets dates, 31 December 20X1 and 20X2 for which annual financial statements were prepared.

### **Analysis as of 31 December 20X1**

8. One criterion in IFRS 5 paragraph 8 requires that the disposal group be actively marketed in order for it to be classified as held for sale. Would Division B qualify as held for sale in the annual financial statements as of 31 December 20X1 before the prospectus is approved assuming all the other criteria in IFRS 5 have been fulfilled?

#### *View 1*

9. Proponents of View 1 believe that Division B would not qualify as held for sale as of 31 December 20X1 since, without an approved prospectus, the disposal group is not being actively marketed. In addition, without a predefined price it cannot be ascertained whether the sales price is reasonable compared with its current fair value.

#### *View 2*

10. Supporters of View 2 believe that an approval for a prospectus is not a mandatory condition in order to classify a disposal group that will be sold by means of an IPO as held for sale. Entity A initiated internal IPO preparations for the sale of Division B investing significant time and resources into the preparation of regulatory and sales documents and engaging external advisors. It has not filed documents with its regulators but it assesses the prospectus’ approval to be highly probable. Management has regularly communicated its plans to the public. It is permitted by law to contact prospective institutional buyers before it receives regulatory approval, which the entity also did. Entity A continues to update its documents to be filed with its regulator, meet weekly with its outside advisors, and monitor market conditions.
11. Likewise, as with a direct sale of an asset, the final price is usually the result of a negotiation process (or in connection with an IPO, the book-building process) and not necessarily presented by the seller

to the buyer at the beginning of the negotiations. Thus, having a final price included in a prospectus is not mandatory in order to classify a disposal group which is to be sold via IPO to qualify as held for sale. Entity A has determined and continues to evaluate internal price ranges and various third-party analysts have commented on their estimated market value of Division B.

### **Analysis as of 31 December 20X2**

12. Due to unfavourable market conditions (finance crisis etc.), the IPO was less likely. If the IPO is not feasible, management has decided to spin off Division B and issue a dividend-in-kind to the shareholders. The Division B shares would then be listed on the stock exchange. Does the change in disposal method to a plan that previously qualified as held for sale under IFRS 5 constitute a change in plan as outlined in IFRS 5 paragraph 26?

#### *View 1*

13. IFRS 5 paragraphs 7 to 9 address the sale of a disposal group while paragraph 12A relates to the disposal through a dividend in kind. Paragraphs 7 to 9 are similar but not identical to paragraph 12A and thus, differentiating between the types of disposal is critical. Both types of transactions are inherently different since a dividend-in-kind does not generate a cash flow for Entity A whereas an IPO does. In addition, the management board can approve an IPO whereas a spin-off must be approved by the shareholders. Proponents of View 1 believe that a classification as discontinued operations can either be based on a sales scenario or on a dividend-in-kind scenario, but alternating between the two qualifies as a significant change in plan (IFRS 5 paragraph 8) and thus, the guidance in IFRS 5 paragraph 26 must be followed.

#### *View 2*

14. IFRS 5 does not define the required level of detail necessary in a disposal plan. Additionally, it does not define whether the plan relates specifically to the method used to dispose of the group or, for example, to the composition of the disposal group. In both the sale and the dividend-in-kind scenarios management's intention to dispose of the disposal group remains unchanged. Only the method of disposal has changed. IFRS 5 paragraph 5A also clarifies that the classification, presentation and measurement requirement in IFRS 5 applicable to a disposal group that is classified as held for sale also apply to a disposal group that is classified as held for distribution to owners. Regardless to whether the disposal group is sold through an IPO or spun off to shareholders, the disposal group will be removed from Entity A. The entity will not principally recover the book value of the disposal group through continuing use (IFRS 5 paragraph 6).
15. Treating the alternative disposal method as a change of plan effectively leads to a reversal of the initial held for sale classification of Division B followed by an immediate re-classification of the same disposal group again as held for sale.

16. Had management defined both alternatives at the onset of the disposal deliberations, no change in the disposal plan would have occurred. As stated in IFRS 5 paragraph 5A, the requirements in IFRS 5 apply to both a sale and a distribution to owners. Thus, expanding the disposal plan to include a dividend-in-kind would not represent a significant change in plan, assuming the criteria in IFRS 5 are otherwise fulfilled.
17. If a disposal does not occur within 12 months of the original designation as held for sale, the entity is required to take actions necessary to respond to the circumstances that were previously considered unlikely and that led to the postponement of the original 12-month disposal target (IFRS 5, Appendix B (c)). Adding the possibility of a spin-off of the division as an alternative mean of disposal of Division B qualifies as an action taken in response to those circumstances. Thus, by adding a different disposal method, the entity is complying with IFRS 5 Appendix B(c) and the designation as held-for-sale should not have been suspended.

#### **Request**

18. Is the approval of prospectus necessary to qualify Division B as held for sale in the annual financial statements as at 31 December 20X1 in light of the various legal restrictions?
19. Assuming all the criteria of IFRS 5 has previously been fulfilled (independent from the response to the first question), should a change in the disposal method from an IPO to a dividend-in-kind qualify as a change in disposal plan as discussed in IFRS 5 paragraph 26.