BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

November 2001

Board Meeting Highlights

The International Accounting Standards Board met in London, UK, on 27-30 November 2001, where it discussed:

- Business Combinations
- Financial Institution Activities
- First-Time Application of IFRS
- Amendments and Improvements to Existing IASB Standards, and
- Insurance Contracts

Business Combinations (Phase I)

The Board considered proposals for a subsequent cash flow test, which would compare the cash flow projections underlying the calculation of the recoverable amount of goodwill against the actual cash flows achieved. The Board tentatively agreed not to include such a test in the revised Standard. However, the Board agreed that users of financial statements should nonetheless be provided with information for assessing the reliability of the estimates used by management to support the carrying amount of goodwill. The Board tentatively agreed that the revised IAS 36, *Impairment of Assets*, should require disclosure of certain information about the calculation of recoverable amount, including:

- the methodology used to determine recoverable amount;
- when recoverable amount is based on value in use:
  - the key assumptions on which management has based its cash flow projections, whether those key assumptions reflect past experience and, if not, why not; and
  - the sensitivity of the cash flow projections to changes in those key assumptions.

The Board tentatively agreed that the requirements in IAS 36 on the basis for estimating future cash flows should be amended to require management to take into account both past cash flows, and its past ability to forecast those actual cash flows, when developing the current cash flow projections. The Board will consider these issues, including the precise nature of the disclosure requirements, at a future meeting.

The Board then considered whether, when a new entity is formed to issue equity instruments to effect a business combination, that new entity or one of the combining entities that existed prior to the business combination should be determined to be the acquirer. The Board tentatively agreed that, in such circumstances, one of the combining entities that existed prior to the business combination should be determined to be the acquirer on the basis of the evidence available.

The Board also considered issues raised in the Improvements Project relating to IAS 22, *Business Combinations*. The Board tentatively agreed that:

- the paragraphs in IAS 22 dealing with the treatment of successive share purchases should be redrafted to clarify their intended meaning. The Board further agreed that, given the apparent level of uncertainty amongst constituents over the accounting for successive share purchases, the revised Standard should include examples illustrating the accounting for such transactions in the following three circumstances:
  - as a result of successive share purchases, an investee previously accounted for at cost is included as a subsidiary in the consolidated financial statements;
  - as a result of successive share purchases, an investee previously accounted for at fair value is included as a subsidiary in the consolidated financial statements; and
  - as a result of successive share purchases, an investee previously accounted for by applying the equity method is included as a subsidiary in the consolidated financial statements.
- the Board agreed, however, that a reconsideration of the accounting for successive share purchases should be undertaken together with the FASB as part of the joint IASB/FASB Business Combinations (Phase II) project on issues related to the application of the purchase method.
- the revised Standard should include additional guidance on the accounting for reverse acquisitions; and
- the revised Standard should be amended to clarify that the costs of registering and issuing equity instruments, even when the proceeds of the equity issue are used to effect a business combination, are an integral part of the equity issue transaction rather than costs directly attributable to the acquisition. Therefore, such costs should, in accordance with SIC-17, *Equity – Costs of an Equity Transaction*, be recognised as a deduction from equity.

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Business Combinations (Phase II)

The Board considered an overview of the Business Combinations (Phase II) project, which it intends to consider adding to its active agenda. Two aspects of the project, the application of the purchase method and new basis accounting, will be run as joint projects with the FASB.

The Board agreed a working principle as the basis for its consideration of issues relating to the application of the purchase method.

Working principle

The accounting for a business combination is based on the assumption that the transaction is an exchange of equal values; the total amount to be recognized should be measured based on the fair value of the consideration paid or the fair value of the net assets acquired, whichever is more clearly evident.

- If the consideration paid is cash or other assets (or liabilities incurred) of the acquiring entity, the fair value of the consideration paid determines the total amount to be recognized in the financial statements of the acquiring entity.
- If the consideration is in the form of equity instruments, the fair value of the equity instruments ordinarily is more clearly evident than the fair value of the net assets acquired and, thus, will determine the total amount to be recognized by the acquiring entity.

In a business combination, the acquiring entity obtains control over the acquired entity and is therefore responsible for the assets and liabilities of the acquired entity. An amount equal to the fair value, on the date control is obtained, should be assigned to the identifiable assets acquired and liabilities assumed.

- If the total fair value exchanged in the purchase transaction exceeds the amounts recognized for identifiable net assets, that amount is the implied fair value of goodwill.
- If the total fair value exchanged in the purchase transaction is less than the amounts recognized for identifiable net assets, that amount should be recognized as a gain in the income statement.

Scope

The Board agreed that the following issues should be included in the scope of the project:

- Issues relating to minority interest:
  - whether a minority interest's share of goodwill should be recognised;
  - whether the purchase of a minority interest should be treated as the purchase of equity;
- the treatment of successive share purchases;
- issues relating to the measurement of consideration for the acquisition:
  - the measurement date for equity securities issued as consideration;
  - the date of acquisition;
  - whether there should be an adjustment from a quoted market price when determining the value of a block of securities issued as consideration;
  - the treatment of direct costs of the acquisition;
  - the recognition and measurement of contingent consideration;
- issues relating to the measurement of the identifiable net assets acquired:
  - the recognition of restructuring provisions, specifically whether the recognition criteria set out in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets,* should be amended;
  - deferred revenue. It was acknowledged that this was a wider issue than recognition of items within a business combination and that the wider context would need to be borne in mind when the issue was considered;
  - income taxes. The requirements of the FASB and IASB Standards on income taxes are not to be reconsidered as part of this project. However the project will include the specific issue of the treatment of acquired deferred tax assets that are recognised after the acquisition;
  - guidance on determining the fair value of liabilities;
  - assets expected to be disposed of;
  - contingencies of the acquired entity; and
  - the period in which the allocation of the fair value of the acquisition to identifiable net assets can be revised.

The scope of the second aspect of the joint project with the FASB, new basis accounting, will be discussed at a future meeting.

First-Time Application of IFRS

The Board discussed a report prepared by an advisory group formed by the French standard setter (Conseil National de la Comptabilité (CNC)) and reached the following tentative conclusions:

- the Board should develop an International Financial Reporting Standard to replace SIC-8, *First-Time Application of IASs as the Primary Basis of Accounting*. The Standard should apply when an entity first states explicitly in its financial statements that those financial statements comply in full with IFRS;
- the main objective of the Standard is to achieve comparability for a first-time adopter over time, and between different first-time adopters that first apply IFRS at the same time. Achieving comparability with entities that already apply IFRS is a secondary objective;
- to satisfy IAS 1, *Presentation of Financial Statements,* an entity's first IFRS financial statements shall present at least one year of comparative figures under IFRS. If the first IFRS financial statements present more than one year of comparative figures, such information shall also comply with IFRS;

- for each period presented, an entity shall use the current version of IFRS in the period of adoption and shall not consider earlier versions of IFRS;
- an entity shall prepare (but need not publish) an opening IFRS balance sheet at the beginning of the earliest period presented in its first IFRS financial statements. This serves as the starting point for subsequent accounting under IFRS;
- in balancing benefits and costs, the Board's benchmark is an entity that plans the transition well in advance and is able to collect most of the information needed for its opening IFRS balance sheet at, or very soon after, the beginning of the earliest period presented in its first IFRS financial statements. The Board does not consider it necessary to grant further relief for entities that prepare their opening IFRS balance sheet at a much later date;
- in its opening IFRS balance sheet, an entity shall recognise all assets and liabilities whose recognition is required by IFRS, and shall not recognise items that do not qualify under IFRS for recognition as assets and liabilities. However, the Board has not yet concluded whether the opening IFRS balance sheet should include intangible assets that satisfy the IFRS recognition criteria but were not recognised under previous local GAAP;
- consistent with IAS 39, *Financial Instruments: Recognition and Measurement*, paragraph 172(h), if an entity entered into a securitisation, transfer, or other derecognition transaction relating to financial instruments in financial years beginning before 1 January 2001, the entity shall not change the accounting for that transaction retrospectively to conform to the requirements of IAS 39. The Staff will ask the IAS 39 Implementation Guidance Committee to review this and other aspects of the treatment of financial instruments in the opening IFRS balance sheet and report back to the Board;
- in its opening IFRS balance sheet, an entity shall apply IFRS in measuring its assets and liabilities. However, if an entity is unable, without undue cost or effort, to determine a cost-based measurement under IFRS for an asset or liability, it shall measure that asset or liability at fair value in its opening IFRS balance sheet, and treat that fair value as deemed cost for subsequent measurement. The entity shall give disclosures about the fact that it is unable to determine a cost-based measurement. Similar principles shall apply if an entity cannot, without undue cost or effort, determine a cost-based measurement adjusted under IAS 29, *Financial Reporting in Hyperinflationary Economies,* for hyperinflation;
- for business combinations that occurred before the beginning of the earliest period presented:
  - An entity shall keep the same classification (as an acquisition, including a reverse acquisition, or uniting of interests) as in its previous local GAAP financial statements;
  - the opening IFRS balance sheet shall include all (and only those) assets and liabilities that meet the IFRS definitions and recognition criteria. An entity shall recognise all resulting adjustments against retained earnings, rather than against goodwill. However, if previously recognised intangible elements acquired in a business combination do not meet the IFRS definition of, and recognition criteria for, intangible assets, the entity shall reclassify those elements as part of goodwill;
  - the amount assigned to the assets and liabilities by the entity under previous local GAAP in a business combination that is an acquisition shall be their deemed cost for subsequent accounting;
  - the entity shall estimate the recoverable amount of any remaining goodwill in the opening IFRS balance sheet, and recognise any resulting impairment loss; and
  - an entity shall not restate the cumulative amortisation of goodwill or negative goodwill (if any) in preparing the opening IFRS balance sheet. The remaining carrying amount shall be amortised prospectively from that point.
- the transitional provisions in current and future Standards and Interpretations shall apply only to transition within IFRS, and shall not apply on transition to IFRS;
- if a new Standard or Interpretation becomes effective after the beginning of the earliest period presented, a first-time adopter shall apply that Standard retrospectively in its first IFRS financial statements. If a new Standard or Interpretation requires (or permits) prospective application by entities that already apply IFRS, the Board plans to consider on a case-by-case basis whether prospective application is also appropriate for first-time adopters;
- if a first-time adopter has not previously tracked translation differences relating to a net investment in a foreign entity, the Standard should not require the first-time adopter to identify the cumulative translation adjustment as a separate component of equity;
- in preparing its opening IFRS balance sheet, an entity shall not use information that was not yet available at the beginning of the earliest period presented;
- an entity's first IFRS financial statements shall include a reconciliation of equity from previous local GAAP to the opening equity under IFRS. The Board will consider whether it should also require disclosure of adjustments that do not affect equity; and
- the Standard should not permit departures from IFRS on the grounds of impracticability.

The Staff plan to submit a draft of an Exposure Draft to the Board in January 2002.

Improvements to Existing IAS

The Board considered issues in respect of which international convergence and/or other improvements to the following International Accounting Standards could be made.

IAS 21, *The Effects of Changes in Foreign Exchange Rates*

The Board tentatively agreed the following:

- to eliminate the allowed alternative in IAS 21, paragraph 21, permitting the capitalisation of certain exchange differences arising from a severe devaluation of a currency;
- to require goodwill and fair value adjustments to assets and liabilities arising on the acquisition of a foreign entity to be translated at the closing rate. However, the Board will keep this issue under review in the context of the proposals being developed on goodwill in the Business Combinations (Phase I) project;
- to remove from the scope of IAS 21 foreign currency derivatives within the scope of IAS 39, *Financial Instruments: Recognition and Measurement*;
- to replace the notion of 'reporting currency' currently in IAS 21 with two notions: *functional currency* (being the currency in which the enterprise measures the items in the financial statements); and *presentation currency* (being the currency in which the enterprise presents its financial statements). Functional currency would be defined as "the currency of the primary economic environment in which the enterprise operates" and much of the material in SIC-19, *Reporting Currency: Measurement and Presentation of Financial Statements Under IAS 21 and IAS 29,* on how to determine a measurement currency would be incorporated into IAS 21. A reporting enterprise (or a foreign operation within a group) would translate its financial statements into the presentation currency (or currencies) using the method set out in IAS 21 paragraph 30. As a result, an enterprise would be able to present financial statements in different currencies and have each of these sets of financial statements be in compliance with IFRS provided the method set out in IAS 21, paragraph 30 is used;
- to eliminate the distinction between integral foreign operations and foreign entities and instead incorporate the indicators of what is an integral foreign operation into the indicators of an enterprise's functional currency. The financial statements of any foreign operation whose functional currency differs from the presentation currency used by the reporting enterprise would be translated using the method set out in IAS 21, paragraph 30;
- to state explicitly that translations (or conversions) 'of convenience' are not contemplated within IFRS;
- to require that any ineffectiveness that arises on a hedge of a net investment in a foreign entity is reported in net profit or loss for the period;
- to move all of the material on hedging currently in IAS 21 to IAS 39; and
- to leave in place SIC-7, *Introduction of the Euro*; to withdraw SIC-11, *Foreign Exchange – Capitalisation of Losses Resulting From Severe Currency Devaluations*; and to incorporate into IAS 21 (subject to the amendments noted above) SIC-19 and SIC-D30, *Reporting Currency – Translation from Measurement Currency to Presentation*.

The Board will consider a revised draft Exposure draft incorporating these decisions at a future meeting.

IAS 23, *Borrowing Costs*

The Board discussed whether to eliminate the choice in IAS 23 either to report all borrowing costs as an expense in the period incurred, or to capitalise borrowing costs that meet certain conditions. In addition to these two alternatives, the Board discussed a possible third approach, namely to capitalise an asset-specific cost of capital (including both a cost of borrowing and a cost of equity capital).

For the purposes of improving IAS 23 and based on the conceptual arguments, the Board inclined towards requiring all borrowing costs to be reported as an expense as incurred. However, the Board agreed to defer taking a decision on this matter until it has discussed it with its liaison standard-setters in January 2002. Requiring expense treatment would not converge IAS 23 to the standards of any liaison standard-setter, and the Board wishes to consider their comments before taking further action.

The Board also decided that, whatever is decided for the improvements project, it wished to revisit the issue (and in particular whether to capitalise an asset-specific cost of capital) in the context of the wider issue of how to measure an asset on initial recognition, agenda priorities permitting.

IAS 33, *Earnings per Share*

The Board agreed that additional guidance should be introduced on more complex matters, such as the effects of contingently issuable shares, contracts that may be settled in shares or cash, participating securities, and the treatment of written put options and purchased options.

The Board considered the conclusion reached in SIC-24, *Earnings per Share: Financial Instruments and Other Contracts that May Be Settled in Shares,* and agreed that when an enterprise has issued a contract that may be settled in common shares or in cash at the issuer's option, those contracts should be included or excluded as potential ordinary shares in the diluted EPS calculation based upon a rebuttable presumption that the contract will be settled in shares. This presumption could be rebutted if the issuer has acted through an established pattern of past practice, published policies, or by making a sufficiently specific current statement indicating to other parties the manner in which it expects to settle, and as a result, the issuer has created a valid expectation on the part of those other parties that it will settle in a manner other than by issuing shares. For contracts in which the holder controls the settlement, past experience or a stated policy is not determinative as the issuer does not have control over the holder's decision. Accordingly, in those situations, the more dilutive of cash or share settlement should be used. SIC-24 will be withdrawn.

When an enterprise acquires its own preferred shares or other securities classified as equity instruments (for example, pursuant to an issuer's tender offer to the holders or inducement by the issuer through favourable changes to the original conversion terms) for an amount different than the recorded book value of those shares, the excess of the consideration given over the carrying amount of preference shares that are classified as equity represents a dividend to the preference shareholder.

Insurance Contracts

The Board reviewed a plan for the project on insurance contracts. The Board noted the interaction with other current or potential projects, such as those on reporting performance, financial instruments and liabilities and revenue recognition.

The Board discussed chapters 1 to 3 of the Draft Statement of Principles (DSOP) prepared by the former IASC Insurance Steering Committee. Chapters 1 to 3 are now available on the IASB's web site. The rest of the DSOP is being finalised and will be posted in December 2001 and January 2002. As a working hypothesis to guide its further work, the Board agreed in broad terms with the principles in chapters 1 and 2 of the DSOP. These are summarised below.

- the project should prescribe the accounting and disclosure in general purpose financial statements by both parties to an insurance contract. The Standard should not address other aspects of accounting by insurers or policyholders, with limited exceptions to be discussed at a later meeting.
- an insurance contract is a contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary (other than an event that is only a change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable).
- a contract creates sufficient insurance risk to qualify as an insurance contract if, and only if, there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer's net cash flows arising from that contract. In considering whether there is a reasonable possibility of such significant change, it is necessary to consider both the probability of the event and the magnitude of its effect.
- a contract that qualifies as an insurance contract at inception or later remains an insurance contract until all rights and obligations are extinguished or expire. If a contract did not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if, and only if, a significant change in the present value of the insurer's net cash flows becomes a reasonable possibility.
- although the following items arise under contracts that may meet the definition of insurance contracts, they should be excluded from the scope of the project (these items are already covered by other standards):
  - financial guarantees (including credit insurance) measured at fair value;
  - product warranties issued directly by a manufacturer, dealer or retailer;
  - employers' assets and liabilities under employee benefit plans (including equity compensation plans);
  - retirement benefit obligations reported by defined benefit retirement benefit plans;
  - contingent consideration payable or receivable in a business combination; and
  - contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, certain licence fees, royalties, lease payments and similar items).
- an insurer or policyholder should not account separately for the components of an insurance contract that bundles together:
  - an insurance element and a non-derivative investment element; or
  - an embedded derivative and a host insurance contract, given the proposal in Chapter 3 of the DSOP for measurement at entity-specific value or fair value.
- there should be a single recognition and measurement approach for all forms of insurance contracts, regardless of the type of risk underwritten.
- insurance assets and insurance liabilities are assets and liabilities arising under an insurance contract. An insurer or policyholder should recognise:
  - an insurance asset when, and only when, it has contractual rights under an insurance contract that result in an asset; and
  - an insurance liability when, and only when, it has contractual obligations under an insurance contract that result in a liability.
- an insurer or policyholder should derecognise an insurance asset or insurance liability or a component of an insurance asset or insurance liability when, and only when, it no longer has the contractual rights or the contractual obligations that resulted in that insurance asset, insurance liability or component.

The Board also began its discussion of chapter 3 of the DSOP, which deals with measurement objectives. The Board will continue its discussion at the next meeting.

Financial Activities

The Board discussed how the scope of the project should be defined. Three approaches were identified:

- a pure activity-based approach extending to all entities that carry out deposit-taking, lending, or securities business activities;
- a pure entity-based approach limited to certain defined types of entities, such as entities subject to banking or similar legislation (as in the existing IAS 30, Disclosures by Banks and Similar Financial Institutions); and
- a mixed approach under which the scope is defined based on both entity and activity-related criteria, such as quantitative tests relating to an entity's or business segment's involvement in deposit-taking, lending, or securities business activities.

The Board decided that the scope should follow the first of these approaches.

Presentation

The Board decided that the project should not specify fixed reporting formats for the financial statements of entities that fall within the scope of the project. The project should instead consider prescribing line items or note disclosures related to deposit-taking, lending, or securities business activities that should be presented in the financial statements of any entity for which that item is material. Definitions of line items should also be considered. Coordination with the reporting financial performance project would be important. Also, it was agreed that the project should develop illustrative formats for the financial statements of an entity that carries out deposit-taking, lending, or securities business activities as its predominant business activities, such as a bank, and perhaps a financial conglomerate.

Disclosure

The Board agreed that it was appropriate to develop principles related to the disclosure of information about risk exposures related to deposit-taking, lending, or securities business activities in this project. The relationship between the disclosure proposals in this project and IAS 32, *Financial Instruments: Disclosure and Presentation,* should be assessed as the project proceeds to avoid overlaps. The Board supported disclosure of information about regulatory capital requirements established by legislation or other regulation. The Board agreed that narrative and numerical information about risk exposure assessment should be provided in the financial statements if such information were to be required. Such an approach does not preclude incorporating the information in the financial statements by way of reference in the financial statements to information provided in material accompanying the financial statements.

Financial Instruments

The Board considered proposals for amendments to IAS 39, *Financial Instruments: Recognition and Measurement*, and IAS 32, *Financial Instruments: Disclosure and Presentation*, that had been developed in consultation with the IAS 39 Implementation Guidance Committee (IGC).

IAS 39

The Board agreed the following related to IAS 39:

- a specific scope exclusion should be added for loan commitments that are neither held for trading nor 'net settled' and that will result in the origination of a loan that will be measured at amortised cost.
- to reduce complexity and eliminate some of the measurement anomalies that arise as a consequence of a mixed measurement model, an entity should be permitted to measure any financial instrument at fair value, with changes in fair value recognised in net profit or loss, by designating it irrevocably at inception as held for trading. An entity should be permitted to use a descriptor of this category other than 'held for trading'. To impose discipline on this approach, an entity is to be precluded from reclassifying financial instruments into (or out of) the category.
- to reduce the burden of separating embedded derivatives, an entity should have the option, rather than being required, to measure a hybrid instrument containing an embedded derivative that is not closely related to the host contract at fair value with changes in fair value reported in net profit or loss.
- the option to recognise gains and losses on available-for-sale financial assets in net profit or loss is no longer necessary. Under the proposed approach, an entity will be permitted to measure any financial instrument at fair value with gains and losses reported in net profit or loss.
- regarding investments in equity instruments, consideration should be given about whether to provide guidance concerning what constitutes objective evidence of impairment. Given the difficulties in determining objectively when impairment losses on equity instruments have been recovered and related measurement and income recognition issues, such losses should not be reversed.
- hedges of firm commitments should be treated as fair value hedges rather than cash flow hedges.
- when a hedged forecasted transaction results in an asset or liability, the gain or loss deferred in equity should not adjust the initial carrying amount of the asset or liability ('basis adjustment'), but should remain in equity and be amortised to net profit or loss.
- the basis for conclusions or introduction should explain some of the reasons why IAS 39 is a complex Standard (including complications that are inherent in a mixed-attribute model based in part on intent, complex finance concepts, and fair value estimation issues). The Board noted that the amendments to IAS 39 would reduce some of that complexity by clarifying

the guidance, eliminating internal inconsistencies, and incorporating much of the existing implementation guidance. While the Board is exploring ways to further reduce the complexity, it is expected that IAS 39 will be in place for a reasonable period of time.

IAS 32

The Board agreed the following related to IAS 32:

- the option in IAS 32 to initially measure the liability element of a compound financial instrument either as a residual amount after separating the equity element or by measuring the elements based on a relative-fair-value method should be eliminated. Instead, any asset and liability elements should be separated first and, then, the residual is the equity element. This is more complicated for instruments with multiple features, for example, a callable convertible debt instrument.

The Board discussed a model of accounting for derivatives on own shares that is based on the principle that only derivatives where the issuer can settle the contract by gross physical delivery of own shares should be classified as equity. The Board will discuss this issue again in January 2002. Support was expressed for treating net cash settled derivatives on own shares as assets or liabilities and for treating forward repurchase and written put obligations to deliver cash and receive shares as liabilities. However, some Board Members expressed concern about the implications of this model for this project and other potential projects. In particular, some questioned the conceptual basis for reporting rights arising from a contract to acquire own shares as an asset. The Board agreed that there is a need to review the definitions and other requirements in IAS 32 and IAS 39 that affect the accounting for contracts on own shares in order to ensure that those requirements can be consistently applied.

Loan Loss Provisions

The Board considered whether IAS 39, paragraph 112, should be amended to clarify whether a loan (or other financial asset) measured at amortised cost that is individually assessed for impairment and found not to be impaired should be included in a group of similar financial assets that are assessed for impairment on a portfolio basis. The Board agreed that individually assessed loans, in groups of loans with shared risk attributes for purposes of assessing impairment that is not reflected in an individual assessment, should be included in a portfolio. The Board agreed that it would be important to consider whether more specific guidance should be provided to put some discipline around a portfolio assessment. The Board decided that it should discuss this aspect of the issue again in early 2002.