BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

March 2002

The International Accounting Standards Board met in technical session in Tokyo, Japan on 19 – 22 March, when it discussed:

- Business combinations
- First-time application of IFRSs
- Improvements to IAS 24 *Related Party Transactions*
- Insurance contracts
- Reporting performance
- Approval of SIC-32
- Share-based payment

In addition, the IASB met the Japanese Accounting Standards Board on 19 March. That meeting was informational in nature and no technical topics were debated or decided.

Business combinations – Phase I

The Board considered a decision summary outlining all tentative decisions made by the Board in phase I of the business combinations project. The Board agreed to proceed with the preparation of pre-ballot exposure drafts incorporating all of those tentative decisions, subject to the following key amendments:

- the exclusion from the scope of the revised business combinations standard of business combinations involving two or more mutual entities or in which separate entities or operations of entities are brought together to form a reporting entity by contract only without the obtaining of an ownership interest should be changed to a delayed effective date. In this way, the accounting for those transactions will continue to be dealt with by IAS 22 *Business Combinations* (revised 1998) until issues surrounding the application of the purchase method to those transactions are resolved.
- the definition of a business combination involving entities under common control should be amended to a business combination in which all of the entities participating are ultimately controlled by the same party (or parties) both before and after the business combination, and that control is not transitory.
- an intangible asset acquired in a business combination should be recognised separately from goodwill if it arises from contractual or legal rights or is separable. The revised business combinations standard should clarify that, with the exception of an assembled workforce, an intangible asset satisfying the criteria for recognition separate from goodwill can be reliably measured. The revised standard should also clarify that an assembled workforce should not be recognised separately from goodwill.
- the fair value of contingent liabilities of the acquiree recognised as part of the apportionment of the cost of acquisition may be approximated using the present value of the amounts that a third party would anticipate in establishing the price it would charge to assume the liability.
- the requirement that an entity should disclose profit or loss of the combined entity as though the date of all business combinations occurring during the reporting period had been at the beginning of the reporting period should be amended to require disclosure unless preparing the disclosure requires undue cost and effort.
- the tentatively agreed amendments to IAS 36 *Impairment of Assets* for the treatment of future tax cash flows in the calculation of value in use and to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* for the treatment of future tax cash flows in the measurement of provisions should not proceed.
- the tentatively agreed disclosures about estimates used to measure the recoverable amounts of groups of cash-generating units containing goodwill or identifiable intangible assets with indefinite useful lives should be amended to clarify that:
  - for each key assumption disclosed, an entity should disclose the amount by which the value assigned to that key assumption must change, incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the recoverable amount of the group of cash-generating units to be equal to its carrying amount.
  - even if the recoverable amount of the group of cash-generating units is based on value in use, the disclosures about key assumptions and changes in those key assumptions need not be made if the net selling price of the group of cash-generating units exceeds its carrying amount and is determined using observable market prices for that group of cash-generating units.

The Board also agreed that the pre-ballot exposure drafts should incorporate the following additional key decisions:

- liabilities that arise as a consequence of the business combination that were not liabilities of the acquiree immediately before the business combination should not be included as part of the apportionment of the cost of acquisition. The list of potential components of negative goodwill should be extended to

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include liabilities that arise as a consequence of the business combination that were not liabilities of the acquiree immediately before the business combination.

- the revised business combinations standard should require identifiable assets and liabilities of the acquiree that do not satisfy the criteria for separate recognition at the time of initially accounting for the business combination to be separately recognised (with a corresponding adjustment to goodwill or negative goodwill) when, subsequent to initially accounting for the business combination, additional evidence becomes available demonstrating that those assets or liabilities satisfied the criteria for separate recognition as at the date of acquisition. If such adjustment is made after the end of the first annual accounting period beginning after the business combination, it should be accounted for as the correction of an error in accordance with IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*. The revised standard should also clarify that identifiable assets and liabilities of the acquiree that do not satisfy the criteria for separate recognition at the time of initially accounting for the business combination but which subsequently satisfy those criteria should not be separately recognised if the additional evidence that becomes available is indicative of conditions arising after the date of the business combination.
- the revised business combinations standard should require the amounts assigned to identifiable assets and liabilities of the acquiree at the time of initially accounting for the business combination and, if necessary, the amount assigned to goodwill or negative goodwill to be adjusted when, subsequent to initially accounting for the business combination, additional evidence becomes available to assist with the estimation as at the date of acquisition of the amounts that should be assigned to those identifiable assets or liabilities. If such adjustment is made after the end of the first annual accounting period beginning after the business combination, it should be accounted for as the correction of an error in accordance with IAS 8.
- the revised business combinations standard should require disclosure in periods following a business combination of any gain or loss related to the assets acquired or liabilities assumed and that is of such size, nature or incidence that disclosure is relevant to an understanding of the combined entity's financial performance.
- the revised business combinations standard should require disclosure of the revenue of the combined entity as though the date of all business combinations occurring during the reporting period had been at the beginning of the reporting period, unless such disclosure would involve undue cost and effort.
- the revised IAS 36 should clarify that goodwill must be allocated to a group of cash-generating units for the purpose of impairment testing before the end of the first annual reporting period commencing after the business combination.
- when a business within a group of cash-generating units to which goodwill has been allocated for the purpose of impairment testing has been disposed of, goodwill associated with that business should be included in the carrying amount of the business in determining the gain or loss on disposal. The amount of goodwill included in that carrying amount should be based on the relative values of the business to be disposed of and the portion of the group of cash-generating units retained.
- when an entity reorganises its reporting structure in a manner that changes the composition of one or more groups of cash-generating units to which goodwill has been allocated for the purpose of impairment testing, goodwill should be reallocated to the groups of cash-generating units affected using a relative value approach similar to that used when a business within a group of cash-generating units is disposed of.
- the revised IAS 36 should clarify that, if an intangible asset that is not being amortised is subsequently reassessed as having a finite useful life, such reassessment should be regarded as an indication that the asset may be impaired and therefore result in the asset being tested for impairment. In addition, IAS 38 *Intangible Assets*, paragraph 94, which requires a change in the amortisation period for an intangible asset to be accounted for as a change in an accounting estimate, should be amended to ensure that this requirement also applies when an intangible asset that is not being amortised is subsequently reassessed as having a finite useful life.
- the 20-year useful life rebuttable presumption in IAS 38 for intangible assets with finite useful lives should not be carried forward to the revised IAS 38.
- IAS 34 *Interim Financial Reporting* should be amended to require information about business combinations occurring during the reporting period that is required to be disclosed under the revised business combinations standard also to be disclosed in interim financial statements.

The Board will consider transitional issues for phase I of the business combinations project at its meeting in April.

Approval of SIC-32

The Board approved the issue of SIC-32: *Intangible Assets – Web Site Costs*, submitted by the reconstituted Standing Interpretations Committee (subsequently renamed the International Financial Reporting Interpretations Committee). SIC-32 states that a web site developed by an enterprise from internal expenditure for internal or external access is an internally generated intangible asset that is subject to the requirements of IAS 38.

In December 2001, the Board withheld its approval of SIC-32 and asked the reconstituted SIC to reconsider one of the conclusions reached by the previous Committee. The reconstituted SIC considered one aspect of the treatment of initial graphic design costs that the Board regarded as important for international convergence, and agreed to change it so that costs are capitalised when certain conditions are met. Further details of SIC-32 are available in the February 2002 issue of *News from the SIC*.

First-time application of IFRSs

The Board discussed the project on first-time application of International Financial Reporting Standards (IFRSs). This is a joint project with the French standard-setter (Conseil National de la Comptabilité (CNC)).

The Board discussed how first-time adopters should account for financial instruments in their opening IFRS balance sheet. The opening IFRS balance sheet is the balance sheet for the beginning of the earliest comparative period presented in the first IFRS financial statements. For example, if an entity's first IFRS financial statements are for the year ended 2005 and include comparative information for one year (2004), the opening IFRS balance sheet is prepared as at 1 January 2004.

An entity may have derecognised financial assets and financial liabilities under its previous GAAP in a transaction that did not qualify for derecognition under IAS 39 *Financial Instruments: Recognition and Measurement*. In the light of the transitional requirements the Board now proposes in the project to improve IAS 39, the Board agreed that an entity should not exclude those financial assets and financial liabilities from its opening IFRS balance sheet.

The Board agreed on the following treatment for hedges, for consistency with the transitional requirements that applied when IAS 39 first became operative.

- If an entity did not designate a transaction as a hedge under previous GAAP before the date of transition to IFRSs, the entity does not designate that transaction as a hedge retrospectively.
- For hedges designated under previous GAAP before the date of transition to IFRSs, an entity applies the recognition, derecognition, and measurement provisions of IAS 39 prospectively, regardless of whether the IAS 39 designation and documentation criteria were met at inception, and regardless of whether the hedge met the IAS 39 effectiveness criteria before the date of transition to IFRSs. In particular:
  - the entity does not reverse the designation of that hedge retrospectively.
  - for fair value hedges of assets and liabilities recognised in the opening IFRS balance sheet (including hedges of firm commitments), an entity adjusts the carrying amounts of the hedged assets and liabilities at the date of transition to IFRSs to reflect the portion of the fair value of the hedging instrument at that date that reflects the risk hedged.
  - if an enterprise's hedge accounting policies under previous GAAP had included deferral of gains or losses on cash flow hedges:
    (i) if the hedged transaction is no longer expected to occur, the entity reclassifies those deferred gains and losses to retained earnings.
    (ii) if the hedged transaction is still expected to occur, the entity classifies those deferred gains and losses as a separate component of equity to the extent that the criteria in paragraph 142 of IAS 39 are met. For this purpose only, the requirement in paragraph 142 for designation and documentation at inception is assessed at the date of transition to IFRSs and there is no requirement to assess whether the IAS 39 criteria for hedge effectiveness were met before that date. The entity transfers the deferred gains and losses to the income statement when the hedged transaction occurs, or when the hedged transaction is no longer expected to occur.

The Board also agreed that an entity recognises the cumulative gains and losses on an available-for-sale financial asset in retained earnings in the opening IFRS balance sheet, rather than in a separate component of equity. The gain or loss on any later disposal includes recycling of only those gains and losses that arose after the date of transition to IFRSs.

Using their previous primary basis of accounting, some entities have revalued items of property, plant and equipment, by applying, for example, a general or specific price index to a cost that is broadly comparable to cost determined under IFRSs, or have revalued the items to an amount that is broadly comparable to fair value determined under IFRSs. The Board agreed that an entity may treat such revalued amounts as deemed cost under IFRSs.

The Board agreed that an entity's first IFRS financial statements should include, among other things, reconciliations of the:

- equity reported in the entity's most recent financial statements under previous GAAP to its equity under IFRSs at the same date;
- equity reported in the entity's opening IFRS balance sheet to its equity under previous GAAP at the date of transition to IFRSs; and
- net profit or loss reported under previous GAAP for the last period in the entity's most recent financial statements to its net profit or loss under IFRSs for the same period.

These reconciliations should give sufficient detail to enable users to understand the main adjustments to each line item on the face of the balance sheet and income statement. An entity shall also explain the main adjustments to each line item of the cash flow statement.

If an entity presents an interim financial report under IAS 34 *Interim Financial Reporting* for part of the annual period covered by its first IFRS financial statements, each such interim financial report includes:

- the reconciliations required in the first IFRS financial statements; and
- if the entity presented an interim financial report for the comparable interim period of the immediately preceding financial year, a reconciliation of the net profit or loss for that period (current and year-to-date) to the net profit or loss under IFRSs.

On completing its discussion, the Board directed the staff to prepare an exposure draft for written ballot.

Improvements to existing IASs

IAS 24 *Related Party Disclosures*

The Board reviewed its decision to provide an exemption from certain disclosures in the IAS 24 *Related Party Disclosures* in the individual financial statements of entities included in a parent's consolidated financial statements. Some Board Members wished to limit the exemption to circumstances in which the individual financial statements are published with (i.e., in the same document as) the consolidated financial statements. Other Board Members thought that it was sufficient that individual financial statements were available separately *or* published with the consolidated financial statements.

The Board agreed that the exemption should apply when the individual financial statements are made available separately or published with the consolidated financial statements.

Insurance contracts

The Board discussed chapter 3 *Measurement Objectives* of the Draft Statement of Principles (DSOP) prepared by the former IASC Insurance Steering Committee (available on the IASB's Website: www.iasb.org.uk). No decisions were taken.

Reporting performance

The Board discussed performance reporting in the specific context of tangible fixed assets. The discussion was broadly in two parts:

- Conceptual and measurement issues concerning the definition of income components for tangible fixed assets
- Performance reporting formats.

Conceptual and measurement issues

The Board focused on the relevance for tangible fixed assets of the distinction between items that represent items of current year performance and items that are predictive of future periods. The wide range of views expressed included the following:

- There is a conceptual distinction between consumption of a tangible fixed asset during a reporting period (i.e. depreciation) and revisions to estimates of future consumable benefits (i.e. revaluation, impairment and disposal gains and losses). These conceptual distinctions are made in IAS 16 *Property, Plant and Equipment* and IAS 36 *Impairment of Assets* and they are the basis of present reporting practice.
- There are considerable practical difficulties in distinguishing income components (egg depreciation and impairment are often difficult to disentangle, with the effect that drawing 'bright lines' between them might lead to misleading reporting).
- Tangible fixed assets are in some respects analogous to financial instruments, e.g., in the case of rental properties. The effect of applying reporting principles to reporting formats for both tangible fixed assets and financial instruments should be consistent.
- A number of Board Members expressed a wish to report separately value changes due to changes in the physical nature of the asset, as opposed to those due to price changes. There was a brief discussion of capital maintenance concepts, and it was noted that financial capital maintenance is being assumed at present.

Discussion of performance reporting formats

The Board discussed whether (in the context of tangible fixed assets) the performance statement should report only one category – i.e., an unstructured format as opposed to the separate categorisation of 'current period' and 'estimate changes affecting future periods'. (These formats are available in the notes released to Observers at the meeting and are available on the IASB's Website.) Although the merits of various formats were discussed, the Board agreed that it was too early in the project to decide on a particular reporting format. The Board asked the staff to continue development of two formats in particular – a format based on a business/ treasury activities categorisation and one utilising a matrix presentation.

The Board noted that the merit of a suggested format based on business/ treasury activities split is that as no additional structure is imposed, such that income components are not reported separately. The merit of an alternative format in which items of performance are reported in a matrix format is that depreciation is separated from other income components in a manner consistent with the performance reporting principles and with IAS 16 and IAS 36.

Share-based payment

The Board considered a project plan prepared by staff, with the objective of publishing an Exposure Draft of an International Financial Reporting Standard by the end of the year.

The Board received a report from the staff on the activities of the Share-based Payment Advisory Group, which has been set up to provide advice on various issues that will be considered by the Board.

The Board had a preliminary discussion of option pricing models. The Board reached the following tentative conclusions, which are based upon the assumption that the IFRS required the use of an option pricing model to estimate the fair value of share options (whether an option pricing model must be used depends upon, amongst other things, the measurement date used and the measurement basis applied at that measurement date):

- The entity should disclose the model used and the inputs to that model (including expected volatility, expected dividends, and the risk-free interest rate).
- In addition to expected volatility, the entity should disclose historical volatility and an explanation of the differences between historical and expected volatility.
- The IFRS should explain how to determine the risk-free interest rate and the entity should disclose how the risk-free interest rate was determined.

The Board had a preliminary discussion of US generally accepted accounting principles relating to share-based payment. Since the discussion was preliminary, no tentative conclusions were requested.

Meeting dates: April – July 2002

The IASB will meet in public session on the following dates. Meetings take place in London, UK, unless otherwise noted.

17 – 19 April

20 – 24 May‡

17 – 21 June – Berlin, Germany†

17 – 19 July

16 – 20 September, Norwalk, Connecticut, USA‡

† Includes a meeting with the Standards Advisory Council

‡ Includes a meeting with partner national standard-setters

