BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

September 2003

The International Accounting Standards Board met in London on 17 – 19 September 2003, when it discussed:

- Business combinations
- Consolidation including special purpose entities
- Convergence issues
- Exploration and evaluation activities
- Financial instruments
- Improvements to existing IFRSs
- Reporting comprehensive income
- Revenue recognition
- Share-based payment
- Small and medium-sized entities

In addition, it met world standard-setters on 22 September 2003 and its partner national standard-setters on 23 September 2003. Reports of these two meetings will be included in the next issue of *IASB Insight.*

Business combinations (phase I)

The Board considered the analyses of the comments received on the questions in the Invitation to Comment on [draft] IAS 38 *Intangible Assets*, and question 2 in the Invitation to Comment on [draft] IAS 36 *Impairment of Assets*. The Board also considered an analysis of the main issues raised during the field visits and roundtable discussions[1] on the criteria for recognising intangible assets separately from goodwill.

[1] The field visits were conducted from early December 2002 to mid-April 2003, and involved IASB members and staff in meetings with 41 companies in Australia, France, Germany, Japan, South Africa, Switzerland and the United Kingdom. IASB members and staff members also, via a series of roundtable discussions, met auditors, preparers, accounting standard-setters and regulators in Canada and the United States to discuss implementation issues encountered by North American companies during first-time application of US Statements 141 *Business Combinations* and 142 *Goodwill and Other Intangible Assets* (and the equivalent Canadian Handbook Sections), which were issued by the FASB/Canadian Accounting Standards Board in June 2001.

Definition of 'identifiable' (question 1 in the Invitation to Comment on [draft] IAS 38)

The Board considered an analysis of the comments received on the proposal that an asset should be treated as meeting the 'identifiability' criterion in the definition of an intangible asset only when it:

(a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

The Board reaffirmed its previous conclusion that the separability and contractual/other legal rights criteria are appropriate for determining whether an asset meets the identifiability criterion. However, the Board agreed to explore further, at a later meeting, some issues related to applying the contractual/other legal rights criteria. In particular, the Board agreed to explore further the question of whether the rights arising from a pending operating or similar licence for which the acquiree applied before the business combination (and which might or might not be granted to the acquiree after the acquisition date) should be regarded as:

(a) meeting at the acquisition date the definition of an intangible asset on the basis that it provides future economic benefits in the form of a legal right to participate in the process of "bidding" for the licence (in which case the asset would, under ED 3, be recognised separately from goodwill); or

(b) meeting at the acquisition date the definition of a contingent asset (in which case the asset would not, under ED 3, be recognised separately from goodwill).

The Board also considered respondents' comments on the relation between the separability criterion for establishing whether a non-contractual customer relationship is 'identifiable', and the 'control' concept for establishing whether the relationship meets the definition of an 'asset'. The Board concluded that, in the absence of exchange transactions for the same or similar non-contractual customer relationships, such relationships acquired in a business combination would not normally meet the definition of an 'intangible asset'—they would not be separable, nor would the entity be able to demonstrate that it controls the future economic benefits flowing from that relationship. The Board agreed to amend paragraph 15 of [draft] IAS 38 to include additional guidance as follows:

> "An entity may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets. <u>In the absence of legal rights to protect customer relationships, exchange transactions</u>

(continued…)

30 Cannon Street,
London EC4M 6XH, United Kingdom
Email: iasb@iasb.org.uk
Website: www.iasb.org.uk

IASB Publications Department,
30 Cannon Street, London, EC4M 6XH
United Kingdom
Tel: +44 (0)20 7332 2730
Fax: +44 (0)20 7332 2749
Email: publications@iasb.org.uk
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Business combinations (phase I) *(continued)*

for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is able to control the future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset."

Criteria for recognising intangible assets acquired in a business combination separately from goodwill (question 2 in the Invitation to Comment on [draft] IAS 38)

The Board considered:

(a) an analysis of the comments received on the proposal that an acquirer should, with the exception of an assembled workforce, always have sufficient information to measure reliably the fair value of an asset that meets the definition of an intangible asset; and

(b) an analysis of the main issues raised during the field visits and roundtable discussions on whether items might exist that meet the definition of an intangible asset, but for which there may not be sufficient information to measure reliably the item's fair value.

After considering respondents' comments and the experiences of field visit and roundtable participants, the Board concluded that, in some instances, there might not be sufficient information to measure reliably the fair value of an intangible asset separately from goodwill, notwithstanding that the asset is 'identifiable'. Therefore, the Board agreed not to proceed with the presumption that sufficient information should always exist to measure reliably the fair value of such an asset.

Nevertheless, the Board remained concerned that 'failing' the 'reliability of measure' recognition criterion might be inappropriately used by entities as a basis for not recognising intangible assets separately from goodwill. The Board's concerns on this issue were heightened by the Board's previous decision that goodwill is an indefinite-lived asset that is not amortised. Therefore, the Board agreed that in the IFRS it would:

(a) clarify that the fair value of an intangible asset acquired in a business combination can normally be measured with sufficient reliability to qualify for recognition separately from goodwill.

(b) clarify that there is a presumption that the fair value of an intangible asset with a finite useful life can be measured with sufficient reliability to qualify for recognition separately from goodwill.

(c) clarify that if, for the estimates used to measure the fair value of an intangible asset, there exists a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the intangible asset's fair value, rather than demonstrates an inability to measure fair value reliably.

(d) clarify that the only circumstance in which it might not be possible to measure reliably the fair value of an intangible asset is when the intangible asset arises from legal or other contractual rights and either (i) is not separable, or (ii) is separable, but there is no history or evidence of exchange transactions for the same or similar assets and estimating fair value is dependent on immeasurable variables.

(e) clarify that if an intangible asset is separable but only together with a related tangible or intangible asset (because they generate jointly the same cash flows), an entity should recognise those complementary assets as a single asset provided they have similar useful lives. The Board agreed to relocate to the IFRS the example in the Draft Illustrative Examples to ED 3 on recognising as a single asset a group of complementary intangible assets commonly referred to as a 'brand'. The Board also agreed to include in the IFRS an additional example to illustrate recognition of complementary intangible and tangible assets as a single asset.

(f) include in the IFRS a requirement for entities to describe each asset that was acquired in a business combination during the reporting period and meets the definition of an intangible asset but was not recognised separately from goodwill, and explain why its fair value could not be measured reliably.

The Board also considered the suggestion from a number of respondents that it should include in the IFRS guidance similar to that included in EITF Issue No. 02-17 *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination.* The Board agreed that EITF 02-17 provides useful guidance on the recognition and measurement issues associated with customer-related intangible assets, and that the guidance in that abstract should be adapted as necessary and included as implementation guidance in the IFRS.

Useful life of an intangible asset (question 3 in the Invitation to Comment on [draft] IAS 38)

The Board reaffirmed its previous decision to remove from IAS 38 the rebuttable presumption that an intangible asset's useful life cannot exceed twenty years, and to require its useful life to be regarded as indefinite when, based on an analysis of all of the relevant factors, there is no foreseeable limit on the period of time over which the asset is expected to generate net cash inflows for the entity.

Useful life of an intangible asset arising from contractual or other legal rights (question 4 in the Invitation to Comment on [draft] IAS 38)

The Board reaffirmed its previous decision that if an intangible asset arises from contractual or other legal rights that are conveyed for a limited term that can be renewed, the useful life should include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. The Board also agreed to include in the IFRS the following additional guidance on whether renewal periods should be included in an asset's useful life:

"Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

(a) there is evidence (possibly based on past experience) that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;

(b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and

(c) the cost to the entity of renewal is not significant compared with the future economic benefits expected to flow to the entity from renewal.

If the cost to the entity of renewal is significant compared to the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date."

Non-amortisation of intangible assets with indefinite useful lives (question 5 in the Invitation to Comment on [draft] IAS 38)

The Board reaffirmed its previous decision that an intangible asset with an indefinite useful life should not be amortised.

Measuring the recoverable amounts of intangible assets with indefinite useful lives, and accounting for impairment losses and reversals of impairment losses (question 2 in the Invitation to Comment on [draft] IAS 36)

The Board reaffirmed its previous decision that the recoverable amount of an intangible asset with an indefinite useful life should be measured, and impairment losses (and reversals of impairment losses) for such an asset accounted for, in accordance with the requirements in IAS 36 for assets other than goodwill.

Business combinations (phase II)

Issues related to the full goodwill method

In November 2002 the Board agreed that the full goodwill method should be used to recognise goodwill in the acquisition of a less than 100 per cent controlling interest in an acquired entity. Under the full goodwill method, all of the goodwill of the acquiree, including goodwill attributable to minority interests, is recognised. Goodwill is measured as the difference between the fair value of the acquiree as a whole and the net fair value of all of the identifiable assets acquired and liabilities assumed at the date control is obtained.

At this meeting the Board continued considering issues arising from the application of the full goodwill method. Specifically, the Board considered the following:

Allocation of the full amount of goodwill between the controlling and minority interests in an acquisition of a less than 100 per cent controlling interest in a subsidiary

The Board considered this issue initially at its March 2003 meeting. The Board agreed that the goodwill attributable to the controlling interest should be calculated as the difference between the consideration paid for that interest and the controlling interest's share of the fair value of the identifiable net assets acquired. The remainder of the goodwill should be allocated to the minority interests.

At this meeting, the Board considered clarifying its previous decisions to deal with allocating goodwill to the controlling and minority interests when, on the date of the business combination:

(a) no consideration is paid by the acquirer; or

(b) the consideration paid does not represent the total controlling interest owned because control was obtained as part of a step acquisition.

The Board agreed that the goodwill initially allocated to the controlling interest should be calculated as the difference between the fair value of the ownership interest acquired and the controlling interest's share of the fair value of the identifiable net assets acquired. The remainder of the goodwill should be allocated to the minority interests. The fair value of the ownership interest acquired should be measured as:

(a) The fair value of the consideration paid by the acquirer on the acquisition date, plus

(b) The fair value on the acquisition date of the acquirer's previous investment in the acquiree.

Allocation of goodwill impairment losses between the controlling and minority interests

The Board agreed that if an entity has one or more partially owned subsidiaries, goodwill impairment losses should be allocated pro rata using the relative carrying values of goodwill.

For example, if the partially-owned subsidiary is part of a larger cash-generating unit, the portion of the impairment loss allocated to that subsidiary would be determined by multiplying the goodwill impairment loss by the carrying value of the goodwill assigned to that subsidiary divided by the carrying value of the goodwill assigned to the cash-generating unit as a whole. The amount of the impairment loss allocated to the partially-owned subsidiary would then be allocated to the controlling and minority interests based on the relative carrying values of goodwill allocated to those interests.

Acquired non-identifiable intangible assets

The Board discussed whether a non-identifiable intangible asset that does not meet the criteria for recognition separately from goodwill at the acquisition date should be subsequently reclassified from goodwill and recognised separately as an intangible asset if it meets the criteria for separate recognition as a result of an event after the acquisition date in the following limited circumstances:

(a) the asset meets the criteria for separate recognition within twelve months of the acquisition date, and

(b) its fair value at the acquisition date is reliably measurable.

To analyse this issue the Board considered two possible examples of contract-based items that might fit the above description:

(i) rights arising from a pending operating licence (when the application for the licence was made before the acquisition date) that is granted to the acquiree after the acquisition date, and

(ii) rights arising from a construction, management, service or supply contract, the terms of which are agreed in principle by the acquiree and the counter-party before the acquisition date, but is finalised and signed soon after the acquisition date.

The Board has not yet reached any conclusions on this issue, and will continue its discussion at a later meeting.

Consolidation including special purpose entities

The purpose of the Board discussion was to consider the concept of control as the basis for consolidation. This initial discussion was focussed on entities other than SPEs, with a view to establishing the general principles. The tentative decisions reached in this meeting will be used as a basis for considering when SPEs should be consolidated.

The main principles tentatively agreed by the Board are set out below.

The Board tentatively decided that the concept of control should require satisfaction of three criteria being:

- the ability to set strategic direction and to direct financing and operating policy and strategy (the 'Power Criterion');
- the ability to access benefits (the 'Benefit Criterion'); and

- the ability to use such power so as to increase, maintain or protect the amount of those benefits.

It was emphasised that control must be assessed based on the circumstances of each case.

The Board tentatively agreed that irrespective of the form of control, if the control criteria are satisfied, consolidation should be required. A controller need not have a minimum level of ownership.

In relation to the Power Criterion it was tentatively agreed that a controller must have a non-shared ability to determine policy and that this criteria shall be satisfied whenever an entity has the ability to dominate policy determination even if it elects not to exercise that power.

In relation to the Benefit Criterion it was tentatively agreed that the types of benefits that satisfy this criterion should be broader than those flowing from a residual ownership interest or in the nature of a residual or ownership benefit and that this criterion would be satisfied whenever an entity has an ability or capacity to obtain benefits, even if such benefits are not actually received.

It was noted that requiring that a controller should be able to use its power so as to increase its benefits, was useful in distinguishing fiduciaries from controllers. The Board agreed that examples should be provided to confirm that when an entity is able to benefit only as a consequence of using its power to benefit its principal (for example, by receiving a performance-linked fee), it is not a controller.

Based upon the above principles, the Board decided that:

- Legal control is not necessary to satisfy the control definition, so control shall include control by those who hold less than a majority voting interest where the balance of holdings are widely dispersed and disorganised, or control through contract.
- Potential voting rights (such as unexercised but currently exercisable holdings of options or convertible notes) may be relevant to the assessment of current control in some circumstances. The Board asked the staff to consider further the circumstances in which it is appropriate to consider potential voting rights in assessing current control.
- There should be no exemption from consolidation because a subsidiary's operations are dissimilar to its controller's operations.
- There should be no exemption from consolidation because an entity adopts measurement models inconsistent with those of the controller.
- Veto rights may negate apparent control, even if those rights are limited to the ability to block actions, if:
    - the veto rights relate to operating and financing policies; and
    - the veto rights relate to decisions in the ordinary course of business and not only to fundamental changes in the organisation (such as disposals of business units or acquisitions of significant assets).

Convergence project

Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

The Board continued its consideration of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* arising from its Business Combinations phase II project.

The Board discussed examples of items that would meet the current definition of a contingent liability in IAS 37. The objective of the discussion was to determine whether all possible obligations that arise from past events are present obligations.

The Board tentatively concluded that not all possible obligations that arise from past events are present obligations. For example, it tentatively agreed that an entity that contaminates a river next to its property but has no legal or constructive obligation to clean up, has no present obligation even if there is a 75 per cent chance of retrospective clean-up legislation being enacted.

Therefore the Board re-examined its decision in ED 3 *Business Combinations* to require the acquirer to recognise separately the acquiree's contingent liabilities at the acquisition date as part of allocating the cost of a business combination (provided that fair values could be reliably measured). The Board agreed that, although the acquiree's contingent liability might not meet the definition of a liability for recognition by the acquiree, the contingent liability gives rise to a 'stand ready' obligation for the acquirer. Expressed another way, the Board agreed that the acquirer should recognise the acquiree's contingent liabilities because, for the acquirer, they are present obligations it has implicitly been paid to assume. The Board agreed to clarify this point in finalising ED 3.

The Board also agreed to reverse its tentative decision in June 2002 to amend the definition of a contingent liability to a "present obligation that arises from past events …". Instead, the Board tentatively agreed that the definition in IAS 37 should be amended as follows:

"a contingent liability is

~~(a)~~ a ~~possible~~ conditional obligation that arises from past events ~~and whose existence will be confirmed only~~ the outcome of which will be resolved by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the ~~enterprise~~ entity.~~; or~~

~~(b) a present obligation that arises from past events but is not recognised because:~~

~~(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or~~

~~(ii) the amount of the obligation cannot be measured with sufficient reliability.~~"

Exploration and evaluation activities

In April 2003, the Board agreed to issue interim guidance to clarify the application of IFRSs and the IASB *Framework* to exploration and evaluation activities and to provide temporary relief from existing IFRSs in some areas. In particular, the Board agreed that:

(a) IFRSs apply to entities engaged in extractive industries activities.

(b) Costs incurred in exploration and evaluation could continue to be accounted for using existing accounting policies.

(c) If the accounting policies adopted treated exploration and evaluation costs as assets, those assets could be exempt from the definition concept of cash-generating units for the purposes of impairment tests under IAS 36 *Impairment of Assets*. However, the Board affirmed that any exploration asset should still be subject to an annual impairment test.

At this meeting, the Board discussed matters arising from comments on a pre-ballot draft on an Exposure Draft that reflected the Board's decisions.

Continuation of previous GAAP for exploration and evaluation costs recognised as an asset

The Board agreed to permit the continuation of previous GAAP for exploration and evaluation costs recognised as an asset (exploration assets). Presentation and disclosure would be those required by IFRSs generally. If an entity that recognised an exploration asset wished to change its accounting for that asset, it should be subject to the requirements for a voluntary change in accounting policy contained in [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The impairment test

The Board agreed that exploration assets should be assessed for impairment at least annually. However, that assessment could be made using a 'cash-generating unit for exploration and evaluation assets' rather than the cash-generating unit defined in IAS 36. The cash-generating unit for exploration and evaluation assets would be the smallest identifiable group of assets that generates cash inflows from continuing use to which impairment tests were applied by an entity in the preparation of its most recent annual financial statements under previous GAAP, provided that this unit was no larger than a business or geographical segment. The Board noted that it could not conceive of a situation in which an entity should assess impairment at a level higher than a segment.

Position of the amendments

The Board agreed that the proposed amendments with respect to recognising exploration assets should be included in IAS 16 *Property, Plant and Equipment*. A cross-reference to IAS 38 *Intangible Assets* would be made. IAS 36 would be amended to reflect the Board's decisions affecting the impairment test for exploration assets.

Next steps

The Board directed the staff to prepare a ballot draft of an Exposure Draft reflecting its comments for its review. Five Board members gave notice that they intended to dissent from the Exposure Draft. The Board expects to issue an Exposure Draft in the final quarter of 2003.

Financial instruments

Improvements to IAS 32 *Financial Instruments: Disclosure and Presentation*

Accounting for the repurchase or induced early conversion of convertible debt

The Board discussed whether IAS 32 should address the accounting for the repurchase of a convertible instrument and for induced early conversion of a convertible instrument.

The Board tentatively agreed to add Application Guidance on the accounting for the repurchase of a convertible instrument. This guidance will state that any premium or consideration paid to extinguish a convertible instrument before maturity through an early redemption or repurchase in which the original conversion privileges are unchanged should be allocated to equity and liability consistently with the method used in the original allocation of the proceeds received by the entity when the convertible instrument was issued.

The Board tentatively agreed not to add Application Guidance on how to account for the induced early conversion of a convertible instrument because the appropriate accounting treatment does not follow directly from the principles in IAS 32 and because the Board is at a late stage in the process of finalising the Standard.

Puttable instruments

The Board tentatively agreed to include in IAS 32 two illustrative examples of an income statement and balance sheet format that might be used by entities whose share capital is not equity as defined in IAS 32. One example would illustrate a possible format for entities that do not have any equity as defined in IAS 32, such as some mutual funds. The second example would illustrate a possible format for entities with some equity, but whose share capital is not equity as defined in IAS 32, such as some co-operatives.

The Board noted that, as a result of consultation with industry groups, this second example had evolved from the one in the Exposure Draft and that agreed at the April meeting.

Improvements to IAS 39 *Financial Instruments: Recognition and Measurement*

Effective interest rate calculations

The Board considered what period should be used when calculating the effective interest rate for financial instruments with a call, put, prepayment or term-extension option. The Board tentatively agreed that in applying the effective interest method entities should calculate the effective interest rate using estimated future cash flows, and amortise any discounts, premiums, directly attributable transaction costs or fees that are an integral part of the effective yield over the period to which they relate. If it is not possible to estimate reliably future cash flows, the entity should use contractual cash flows over the full contractual term of the financial instrument or group of financial instruments. The Board also agreed that the definition of the effective interest rate should state that expected, but not incurred, credit losses are not considered in the calculations. If an entity purchases a financial asset at a deep discount because of previously incurred credit losses, these credit losses are included in the estimated cash flows.

The Board considered accounting for subsequent changes in estimates used in calculating the effective interest rate. The Board tentatively agreed that if an entity revises its estimates of payments or receipts, the entity should adjust the amortised cost of the instrument to reflect actual and revised estimated cash flows. The adjustment is recorded as income or expense in profit or loss. The entity recalculates the amortised cost by discounting the amount received or paid in the current period, and the remaining estimated cash flows using the original effective interest rate.

The Board considered and tentatively agreed not to include guidance in IAS 39 on how an entity should account for a modification of the terms of a financial asset other than as a result of financial difficulties of the borrower.

Derecognition issues

The Board made the following tentative decisions regarding derecognition issues:

(a) to amend the conditions for a pass-through arrangement set out in paragraph 41(a) and (c) of the Exposure Draft to clarify that:

   (i) short-term advances by the entity with right of full recovery of the amount lent plus accrued interest at market rates do not violate the condition in paragraph 41(a) and

(ii) the condition in paragraph 41(c) is met only if the entity has both an obligation to remit any cash flows it collects on behalf of recipients without material delay and is not entitled to reinvest such cash flows except for investments in cash and cash equivalents, and when interest earned on such reinvestments is passed to the eventual recipients.

(b) when measuring collars under the continuing involvement approach, if the asset was measured at fair value before the transfer, it will continue to be measured at fair value. The related borrowing will be measured so that the net carrying amount of the asset and the borrowing equals the fair value of the collar as a stand-alone instrument.

(c) to include finance lease payables, recognised under IAS 17, within the scope of IAS 39 for derecognition purposes only.

(d) to add one additional example in the Application Guidance of IAS 39 dealing with application of the derecognition model to an asset that is not readily obtainable and is subject to a written put option.

Loan servicing rights

The Board tentatively agreed not to amend IAS 39 to permit loan servicing rights to be included within its scope provided they are measured at fair value with all changes in fair value being recognised immediately through profit or loss.

Hedge accounting: internal transactions

During its meeting in May the Board reconfirmed the position in the original IAS 39 and the Exposure Draft that internal contracts should be eliminated in consolidated financial statements and that only external transactions may be designated as hedging instruments in group financial statements. During its September meeting, the Board considered the view expressed by some constituents that IGC 134-1-b *Offsetting internal derivative contracts used to manage foreign currency risk* is interpreted as permitting the designation of internal derivative contracts as hedging instruments in consolidated financial statements despite the Standard prohibiting such designation. The Board tentatively agreed to clarify IGC 134-1-b to avoid such an interpretation in the future.

Implications of removing the distinction between originated and purchased loans

The Board discussed a concern about its decision in July 2003 to treat purchased loans in the same way as originated loans. The concern was that some financial instruments, such as a debt instrument in which the purchaser may not recover its investment, could fall within the loans and receivables category and be measured at amortised cost. Another example is an interest-only strip created in a securitisation and subject to prepayment risk.

The Board tentatively agreed to restrict the loans and receivables category to exclude those instruments on which the holder may not recover substantially all of its initial investment other than because of credit deterioration.

The Board also tentatively agreed to add examples to the Application Guidance to illustrate what this additional condition is intended to capture.

Transition to IASs 32 and 39

In July 2003, the Board agreed that for first-time adopters of IFRSs:

(a) the transition to IAS 39 would be as specified in IFRS 1 *First-time Adoption of International Financial Reporting Standards*, except that a first-time adopter that had derecognised financial assets or financial liabilities under its previous GAAP before 1 January 2004 would not be required to recognise those assets and liabilities under IFRSs (except for derivatives), unless they qualify for recognition as a result of a later transaction or event. (At present, IFRS 1 requires recognition of financial assets and financial liabilities derecognised under previous GAAP after 1 January 2001.)

(b) entities adopting IFRSs for the first time in 2005 would not be required to restate comparative financial statements to incorporate the requirements of IAS 39. However, such entities would be required to provide a reconciliation between amounts recognised at the end of the comparative period (for an entity with a December year-end, 31 December 2004) and those recognised at the beginning of the next period (for an entity with a December year-end, 1 January 2005).

(c) restated comparative financial statements would be required for IAS 32.

In September 2003, the Board tentatively agreed to amend IFRS 1 to permit entities adopting IFRSs for the first time in 2005 not to restate comparative financial statements to incorporate the requirements of IAS 32. Such entities would be required to provide the same reconciliation as required for IAS 39 information. The Board noted that, in some cases, the information required to restate comparative financial statements in accordance with IAS 32 would not be onerous to prepare. However it concluded that an approach that is consistent with IAS 39 would be preferable.

The Board also tentatively agreed to clarify that the statement in July 2003's *IASB Update* that "a first-time adopter that had derecognised financial assets or financial liabilities under its previous GAAP before 1 January 2004 would not be required to recognise those assets and liabilities under IFRSs, unless they qualify for recognition as a result of a later transaction or event" applied only to non-derivative financial assets and non-derivative financial liabilities.

Improvements to existing IFRSs

The Board discussed issues on the following Standards revised in its project on 'Improvements to International Accounting Standards':

IAS 2 *Inventories*

Effect on entities using replacement cost

The Board confirmed that it did not have any further comments on the Objective and Scope sections in relation to the deletion of the reference of 'historical cost' and the related effect on entities using a basis other than cost, for example, replacement cost. To the extent not already dealt with in IAS 29 *Financial Reporting in Hyperinflationary Economies*, the Board agreed that this issue should be considered in any future Board project on high inflation.

Disclosure

The Board decided that entities would not be required to disclose the carrying amount of inventories at net realisable value. However, the Board confirmed that entities would have to disclose the amount of any write-down of inventories in accordance with the Exposure Draft. The Board also agreed that entities are required to disclose the carrying amount of inventories carried at fair value less costs to sell.

The Board instructed the staff to clarify in the Scope that entities that are excluded from the measurement requirements are still subject to the disclosure requirements. The Board also instructed the staff to clarify in the Basis for Conclusions the distinction between net realisable value and fair value less costs to sell.

IAS 16 *Property, Plant and Equipment*

The Board made the following decisions on exchanges of property, plant and equipment:

(a) to adopt the following wording for ‘commercial substance’:

“An entity determines whether an exchange transaction has commercial substance by considering the degree to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing, and amount) of the expected future cash flows of the asset(s) received differs from the configuration of the expected future cash flows of the asset(s) transferred, or

(b) the entity-specific value of the portion of the entity’s operations affected by the transaction changes as a result of the exchange, and

(c) either of the differences in (a) or (b) is significant relative to the fair value of the assets exchanged.”

(b) to define ‘entity-specific value’ as follows:

“Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life.”

The Board noted that the definition was the same as that for ‘value in use’ in IAS 36 but agreed that in the context of giving guidance on ‘commercial substance’ it was important to use exactly the same wording as the FASB is considering adopting in its guidance on the same issue.

(c) to add guidance on the discount rate that should be used in calculating entity-specific value.

(d) to note that, for the purposes of determining whether an exchange transaction has commercial substance, the entity-specific value should include tax effects.

IAS 33 *Earnings per Share*

The Board confirmed that it wished to proceed with guidance that shares that will be issued upon the conversion of a mandatorily convertible security should be included in the calculation of basic earnings per share from the date the contract is entered into, even though US GAAP is currently silent on this issue. The Board agreed to ask the FASB to consider the issue as part of its short-term convergence project on earnings per share.

IAS 27 *Consolidated and Separate Financial Statements*

Financial statements of parents exempted from consolidation

The Board decided that a parent exempted from the requirement to prepare consolidated financial statements because a superior parent in the group prepares IFRS consolidated financial statements should prepare its financial statements in the same manner as for parents that prepare separate financial statements.[2] This means that intermediate parents, investors and venturers should prepare separate financial statements on the same basis when accounting for investments in subsidiaries, associates and joint venture entities as they would prepare separate financial statements in addition to those prepared in accordance with IAS 27, IAS 28 and IAS 31, ie the cost method or as required under IAS 39. The basis for exempt parents not having to apply the equity method or proportional consolidation is the same as for them not having to consolidate. (That is, the costs are likely to exceed the benefits when separate financial statements are prepared in addition to consolidated financial statements, although for exempt parents the additional consolidated financial statements are produced at a higher level within the group.) Furthermore, such financial statements will in all cases be prepared with a focus on the investments held by the parent, investor or venturer as an investor rather than regarding them as part of a group.

IAS 28 *Investments in Associates*

Equity Method of Accounting: Reporting Date Differences

The Board confirmed the proposal in the Exposure Draft that when the reporting dates of an investor and an associate cannot be conformed for the purposes of applying the equity method, the difference between their reporting dates should be no more than three months. Beyond that period the information is likely to be stale and the ability to adjust sufficiently is not possible.

Equity Method of Accounting: Uniform Accounting Policies

The Board also confirmed that in applying the equity method in IAS 28 entities should make adjustments to conform an associate’s accounting policies to those of the entity. Despite difficulties that they acknowledged might arise in practice, the Board reaffirmed that consistency in accounting policies was a required attribute of financial reporting.

Revenue recognition

The Board received a presentation from the UK Accounting Standards Board staff on an ASB paper *Revenue Recognition: the EITF Approach, the Wholesale Approach and the Retail Approach*, which was prepared at the Board’s request. The ASB paper discussed whether the fair value of a contractual obligation to a customer should be determined in the wholesale or retail market, and the implications of that choice for the timing of revenue recognition. It illustrated these approaches to measuring fair value using the case studies in EITF Issue 00-21 *Revenue Arrangements with Multiple Deliverables*, and assumed that payment was received from the customer upon entry into the contract.

The wholesale approach to fair value measures a contractual obligation to a customer at the price the entity would need to pay to a third party to assume its performance obligation to the customer and its performance guarantee.

The retail approach measures the obligation at the price for the deliverables in the retail market, which generally is the amount received or receivable from the customer. If the retail price of each deliverable is a similarly reliable indicator of fair value, the arrangement consideration is allocated to the deliverables based on their relative retail prices.

The ASB paper commented that because wholesale prices are generally lower than retail prices, under the wholesale approach the contractual obligation to the customer is generally less than the amount received from the customer, and the difference between these amounts would be recognised as revenue when the customer consideration is received or receivable. In contrast, under the retail approach, revenue is recognised only when the entity performs its contractual obligation to its customer. The ASB favours using the retail approach to measure the fair value of contractual obligations to customers.

The Board discussion was for information only, and no Board decisions were made.

Consideration of how to apply the Board’s proposed conceptual model for accounting for contractual rights and obligations to long-term construction contracts, service contracts and real estate contracts was deferred to a future meeting.

[2] ‘Separate financial statements’ can mean both financial statements prepared *in addition to* the entity’s own consolidated financial statements and those prepared *as* the entity’s own financial statements because consolidated financial statements are prepared by a parent entity further up in the group.

Share-based payment

The Board continued its redeliberations of the proposals in ED 2 *Share-based Payment*, in the light of comments received. The Board first reviewed a revised project plan prepared by staff, setting out the remainder of issues to be considered and a revised publication timetable. The Board expects to issue the IFRS in the first quarter of 2004. The Board then discussed various issues, set out below.

Definition of grant date

The Board discussed the definition of grant date proposed in ED 2, focusing on specific examples. The Board tentatively agreed that the Implementation Guidance should include some explanatory guidance on the definition.

Measurement of transactions with parties other than employees

The Board continued its discussions, begun at its July meeting. The Board tentatively agreed that for equity-settled transactions, the general requirements should be as follows:

- The entity should measure the goods or services received, and the corresponding increase in equity, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the fair value cannot be estimated reliably, the entity shall measure the goods or services received, and the corresponding increase in equity, by reference to the fair value of the equity instruments granted.
- For services received from employees or other parties providing similar services, the entity should measure the transaction at the fair value of the equity instruments granted, because it is typically not possible to estimate reliably the fair value of the services received.
- For other goods or services received (other than services received from employees or other parties providing similar services) that are within the scope of the IFRS (see below), the entity should measure directly the fair value of the goods or services received.

The Board also tentatively agreed to retain the proposal in ED 2 that:

- for transactions measured at the fair value of the goods or services received, the fair value of goods or services received should be measured at the date of receipt.
- for transactions measured by reference to the fair value of the equity instruments granted, the fair value of those equity instruments—whether to employees or non-employees—should be measured at grant date.

Interaction between ED 2 and IAS 32

There are some differences between the classification of contracts on own shares as liabilities or equity under the proposals in ED 2 and the proposed revisions to IAS 32 *Financial Instruments: Disclosure and Presentation*, as is acknowledged in the Basis for Conclusions to ED 2. Except for arrangements with cash alternatives, the Board tentatively agreed to retain the differences between ED 2 and IAS 32 in the short-term, pending the outcome of the Board's concepts project, which includes reviewing the distinction between liabilities and equity.

For arrangements with cash alternatives, the Board tentatively agreed to align the requirements of the IFRS with IAS 32. Thus, irrespective of whether the counterparty or the entity has the choice of settlement, the transaction is accounted for as a cash-settled transaction to the extent of the cash alternative, with the equity component (if any) accounted for as an equity-settled transaction. The Board noted that this approach differs from the approach applied in FAS 123 *Accounting for Stock-Based Compensation*, which the FASB recently tentatively agreed to retain. Therefore, this issue will be discussed at the joint meeting with the FASB to be held in October.

The Board also discussed the scope of each standard. The Board tentatively agreed that the IFRS on share-based payment should apply to the following share-based payment transactions:

- transactions with employees and others providing similar services
- transactions for the purchase of other goods and services in which the entity is able to estimate reliably the fair value of the goods or services received, and the arrangement was entered into and continues to be for the purposes of taking delivery of the goods or services in accordance with the entity's expected purchase, sale or usage requirements, including arrangements in which the entity does not have the ability to require delivery of the goods or services.

All other share-based payment transactions will be within the scope of IAS 32 and IAS 39.

Arrangements with cash alternatives

For share-based payment transactions in which either the entity or the supplier of goods or services may choose whether the entity settles the transaction in cash or by issuing equity instruments, ED 2 proposed that the entity should account for the transaction, or the components of that transaction, as a cash-settled share-based payment transaction if the entity has incurred a liability to settle in cash, or as an equity-settled share-based payment transaction if no such liability has been incurred. ED 2 proposed various requirements to apply this principle.

The Board reviewed a staff analysis of respondents' comments. Many respondents agreed with the proposals in ED 2, although some expressed reservations and some disagreed. For example, some respondents commented that the proposed approach was complex and that further guidance was required.

The Board tentatively agreed that the example in the Implementation Guidance should be moved to an appendix to the IFRS, simplified to the extent possible, and extended to explain what happens between grant date and settlement date, under various scenarios.

The Board also tentatively agreed to align the requirements in the IFRS with those in the revised IAS 32, as noted above.

ESOPs, ESPPs and broad-based employee share plans

ED 2 did not contain any exemptions or any specific guidance in respect of employee share ownership plans (ESOPs), employee share purchase plans (ESPPs) or broad-based employee share plans. The Board considered respondents' comments. Some respondents argued that broad-based employee plans should be exempted from the IFRS, some argued that a limited exemption be given, such as that contained in FAS 123, and some respondents argued that no exemptions should be given.

The Board tentatively decided that the IFRS should not contain exemptions for types of employee share plans, including broad-based plans, ie the approach proposed in ED 2 should be retained. However, if an employee were also a shareholder, then any benefits made available to all shareholders, such as the right to acquire the entity's shares at a discounted price, would not be within the scope of the IFRS. The Board also tentatively agreed to ask the IFRIC to consider whether SIC-12 *Consolidation – Special Purpose Entities* should be amended to remove the scope exclusion for equity compensation plans and, if so, whether any guidance on accounting for ESOPs should be given.

Valuation issues, including restricted stock and unlisted entities

The Board discussed valuation issues at its June and July meetings, and reached various tentative decisions, for example, on the valuation of employee share options. At this meeting, the Board discussed:

- *Unlisted entities*. ED 2 did not propose any exemptions or concessions for unlisted entities. The Board tentatively agreed that for transactions measured at the fair value of the equity instruments granted, if the entity could not estimate reliably the grant date fair value of the equity instruments granted, the entity should measure the equity instruments at their intrinsic value, and remeasure intrinsic value until exercise date. This requirement will apply to both listed and unlisted entities.
- *Restricted stock*. ED 2 did not contain any specific guidance on the valuation of restricted stock. The Board tentatively agreed to provide guidance to clarify that the estimate of the fair value of restricted stock at grant date:
  - should not be adjusted for pre-vesting restrictions, because those restrictions stem from the forfeitability of the instruments, and the effects of forfeiture are dealt with via the modified grant date method.
  - should take into account the effects of any post-vesting restrictions, if the effect is likely to be significant, which is unlikely in most cases (this will be explained in the Basis for Conclusions).
- *Option pricing models*. At the July Board meeting, the Board tentatively agreed that the IFRS should not specify which option pricing model should be applied. At this meeting, the Board confirmed that decision, and tentatively agreed to provide guidance on the circumstances in which particular types of option pricing models are more appropriate than others. This will include guidance similar to the guidance on valuation techniques included in IAS 39.
- *Other issues*. The Board received a report from the staff on tentative decisions reached by the FASB relating to valuation issues discussed at a recent FASB meeting. The Board noted that the FASB has reached a different decision about the treatment of reload features, and therefore this issue will be discussed at the joint meeting with the FASB in October.

Transitional arrangements and effective date

ED 2 proposed that the IFRS should become effective on 1 January 2004. It also proposed that the IFRS should apply to equity instruments granted after the date of publication of the ED (7 November 2002) that had not vested at the effective date. ED 2 proposed retrospective application to liabilities existing at the effective date, except that entities would not be required to measure liabilities in respect of vested share appreciation rights (and similar rights) at fair value, but instead should measure such liabilities at their settlement amount.

The Board considered a staff analysis of respondents' comments. Some respondents disagreed with the partial retrospective approach proposed in ED 2. For example, some argued that the IFRS should be applied prospectively, and others argued that full retrospective application should be required, or at least permitted. Some respondents argued that the effective date should be 1 January 2005, to align with the adoption of IFRSs by EU listed companies.

The Board noted that because the IFRS would not be issued by the end of the year, the proposed effective date was no longer appropriate. The Board tentatively agreed that the IFRS should become effective from 1 January 2005. For the transitional arrangements, the Board tentatively agreed:

- to retain the proposal in ED 2 that the IFRS should apply to equity instruments that were granted after the publication date of the ED (7 November 2002) and had not vested at the effective date.
- to permit, but not require, full retrospective application to other grants of equity instruments, if the entity has disclosed publicly the fair value of the equity instruments at grant date. For example, entities that have disclosed the information required by FAS 123 in the notes to their financial statements may apply the IFRS retrospectively in full.
- to require that if, after the IFRS becomes effective, an entity modifies the terms or conditions of equity instruments granted before 7 November 2002, the requirements of the IFRS concerning such modifications must be applied, so that the incremental fair value granted is recognised.
- to modify the transitional arrangements for cash-settled transactions, to require retrospective application to liabilities existing at the effective date of the IFRS, except that entities would not be required to restate comparatives earlier than 7 November 2002.
- to permit, but not require, full retrospective application to liabilities arising from cash-settled transactions.
- to modify the transitional arrangements for first-time adopters to reflect the changes agreed above.

Disclosure

ED 2 proposed that an entity should disclose information to enable users of financial statements to understand:

- the nature and extent of share-based payment arrangements that existed during the period,
- how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined, and
- the effect of expenses arising from share-based payment transactions on the entity's profit or loss.

In addition, ED 2 proposed specific disclosure requirements to satisfy these disclosure principles.

The Board reviewed respondents' comments on the proposed disclosure requirements. Respondents had mixed views. For example, some agreed unreservedly with the proposed requirements, some agreed with reservations, and some disagreed. Some respondents stated that the disclosures were excessive. However, some suggested additional disclosures.

The Board tentatively agreed to retain the disclosure principles proposed in ED 2. The Board also tentatively agreed to some deletions and modifications of the proposed detailed requirements, in the light of respondents' comments and earlier Board decisions, for example, to replace the units of service method with the modified grant date applied in FAS 123.

Small and medium-sized entities

The Board continued its discussion of an approach to a project on accounting standards for small and medium-sized entities (SMEs) and reached the following tentative decisions:

- The Board should develop accounting standards appropriate for small and medium-sized entities (IASB SME standards).
- The Board should describe the characteristics of SMEs for which it intends the standards. These characteristics should not prescribe quantitative "size tests" but rather consider qualitative factors such as public accountability. National

jurisdictions should determine which, if any, entities should be permitted or required to follow IASB SME standards.

- Development of IASB SME standards should start by extracting the fundamental concepts from the IASB *Framework* and the principles and related mandatory guidance from IFRSs and related Interpretations.
- Any modifications to these concepts or principles must be based on the identified needs of users of SME financial statements.
- It is likely that disclosure and presentation modifications will be justified based on user needs. The disclosure modifications could increase or decrease the current level of disclosure.
- There would be a rebuttable presumption that no modifications would be made to the recognition and measurement principles in IFRSs. Such modifications can only be justified based on user needs and cost/benefit analysis.
- If IASB SME standards do not address a particular accounting question, full IFRSs would be a mandatory fallback.
- IASB SME standards should be published in a separate printed volume. In the electronic version of the Standards, IASB SME standards should be integrated with full IFRS.
- The Board will decide in the future how IASB SME standards should be labelled or described in the basis of presentation note.

Meeting dates: 2003-2004

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

2003

22—24 October, Toronto, Canada§

17—21 November†

17—19 December

2004

21—23 January

18—20; 23, 24 February†

17—19 March

21—23; 26,27 April‡

19—21 May

21—25 June, Stockholm, Sweden†

21—23 July

22—24; 27, 28 September‡

20—22 October, Norwalk, Connecticut, USA

15—19 November†

15—17 December

† Includes a meeting with the Standards Advisory Council

‡ Includes meetings with partner standard-setters

§ Includes meetings with the Canadian and US national standard-setters