BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

December 2004

The International Accounting Standards Board met in London on 15, 16 and 17 December, when it discussed:

- IAS 39 – Cash Flow Hedge Accounting of Forecast Intragroup Transactions
- IAS 39 and IFRS 4 – Financial Guarantees and Credit Insurance
- IAS 39 – Amendments: Transition
- IAS 39 – Amendments: Fair Value Option
- ED 7 *Financial Instruments: Disclosures*
- Business Combinations Phase II – Purchase Method Procedures
- IAS 37 – Amendments: Measuring termination benefits
- Revenue Recognition
- Small and Medium-sized Entities
- IFRIC matters

IAS 39 – Cash Flow Hedge Accounting of Forecast Intragroup Transactions

In July 2004, the Board issued an Exposure Draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement on Cash Flow Hedge Accounting of Forecast Intragroup Transactions*.

At this meeting, the Board held a public education session about two transition issues raised by constituents. These issues arise because any amendments to IAS 39 as a result of the Exposure Draft will not be finalised when IAS 39 (as revised in 2003) comes into effect (accounting periods beginning on or after 1 January 2005).

The transition issues are a consequence of the interaction of several provisions of IAS 39 and the Exposure Draft proposals. The previous version of IAS 39, as interpreted by IGC 137–14 *Forecasted intra-group foreign currency transactions that will affect consolidated net income*, allows the designated hedged item to be a highly probable forecast *intragroup* transaction in consolidated financial statements. However, IGC 137–14 was withdrawn when the revised IAS 39 was issued. Consequently, the Exposure Draft proposed to clarify that the revised IAS 39 requires the designated hedged item to be a highly probable forecast *external* transaction. In addition, IAS 39 does not permit retrospective designation of hedges.

The transition issues are:

- What should entities designate as the hedged item from 1 January 2005, so as to be able to obtain hedge accounting for 2005 and later periods – highly probable forecast external transactions or highly probable forecast *intragroup* transactions? This issue arises for both existing users of IFRSs and entities adopting IFRSs for the first time from 2005.
- For existing users of IFRSs, what will be the effect of adopting IAS 39 (as revised in 2003) on comparative information (ie information for 2004 and earlier periods)? As the revised IAS 39 applies retrospectively, it would seem that comparative information for 2004 and earlier periods would need to be restated. This issue arises only for existing users of IFRSs - those adopting IFRSs for the first time from 2005 are not required to restate comparative information in accordance with IAS 39.

The Board noted that it could not make any decisions about transitional matters until decides how to finalise the proposals in the Exposure Draft. However, Board members appreciated the difficulties being faced by constituents and agreed that these concerns would be important considerations when the transition requirements for any amendments are determined.

On the first issue, the Board noted that IAS 39 does not require a single method of designation for all types of hedges. A hedge may be designated one way for the purposes of the consolidated financial statements and another way for the purposes of the separate financial statements of a subsidiary. For example, in the period after an entity adopts IAS 39 (as revised in 2003) until the Exposure Draft is finalised, an entity could designate the hedged item to be both a highly probable *external* transaction at the group level and a highly probable *intragroup* transaction at the subsidiary level.

The Board made no decisions on how to proceed with the Exposure Draft. It expects to discuss the comment letters received and issues arising from them at its February meeting.

IAS 39 and IFRS 4 – Financial Guarantees and Credit Insurance

In July 2004, the Board published an Exposure Draft on Financial Guarantees and Credit Insurance, proposing amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 4 *Insurance Contracts*. At this meeting, the Board held an education session to receive briefings from representatives of:

- the International Credit Insurance & Surety Association (ICISA)
- the Association of Financial Guaranty Insurers (AFGI)

Slide presentations used by the representatives are available at http://www.iasb.org/meetings/0412ob.asp

No decisions were made. The Board expects to discuss comment letters on the Exposure Draft at its meeting on 17-21 January 2005.

(Continued…)

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IAS 39 – Amendments: Transition

At its November 2004 meeting, the Board decided to finalise an amendment to IAS 39 to provide transitional relief for gains and losses previously recognised on the initial recognition of financial instruments.

At this meeting, the Board debated various issues that arose from reviewing the pre-ballot draft of the amendments. It reaffirmed the following decisions:

- it is beyond the scope of this limited project to assess when an entity should use straight-line amortisation to amortise the difference between a transaction price (used as fair value on initial recognition in accordance with IAS 39 paragraph AG76), and a valuation made at the time of the transaction that was not based solely on data from observable markets.
- to note in the Basis for Conclusions that straight-line amortisation would not be appropriate in all circumstances.

The final amendments were published on the subscriber section of the IASB Website on 17 December.

IAS 39 – Amendments: Fair Value Option

In April 2004, the Board published an Exposure Draft of proposed amendments to IAS 39's fair value option. In September, it discussed the 116 comment letters received. The Board noted that a large majority of respondents did not agree with the proposals in the Exposure Draft, including a majority of respondents in all categories except regulators. It also noted that reverting to the unrestricted fair value option in IAS 39 (as amended in March 2004) would not address the concerns of regulators, which were the reason for publishing the Exposure Draft. Therefore, the Board had asked the staff to explore whether there was an alternative solution that could be acceptable to all parties – the Board, regulators and other constituents.

Since September, a possible approach has been developed by some in the banking industry. This approach would permit use of the fair value option only for a financial asset or financial liability that is part of a group of financial assets and financial liabilities that are managed together on a fair value basis in accordance with a documented risk management strategy, and only part of this group is required or permitted to be measured at fair value. The Board was concerned about whether this approach could be made operational and whether it could be applied outside of the banking sector, eg to insurers, commercial entities, investment trusts and venture capital entities.

The Board then considered an alternative approach that had been developed by IASB staff with the help of a few Board members (A preliminary draft of this proposed new approach is included in the observer notes for this meeting, which are available on the IASB Website). It noted that this proposed new approach had been sent to various parties, with a request to notify the staff of any major issues by 1 January. The staff reported that some comments had already been received. A small number of constituents supported the approach, but a larger number expressed concern that it would prevent use of the fair value option in situations when they consider measurement at fair value through profit or loss to be appropriate. Many would prefer the unrestricted fair value option presently contained in IAS 39, although they agreed that the proposed new approach was superior to the approach proposed in the Exposure Draft. On the other hand, some bank regulators had expressed concern that the proposed new approach was not sufficiently restrictive.

The Board agreed with constituents that this proposed new approach was superior to the approach proposed in the April Exposure Draft and supported its further development. It asked the staff to explore how to explain better the principles underlying the approach so as to make it more operational. This might include adding more examples of when use of the fair value option would and would not be permitted; however, the Board did not support redrafting the examples as an exhaustive list of the only situations in which the fair value option could be used. It also asked the staff to consider carefully any comments and suggestions from constituents and report back at the January 2005 Board meeting. Lastly, the Board expressed a desire to understand better the concerns of some bank regulators.

The Board confirmed its intention to hold one or more public meetings in the first quarter of 2005, to which it would invite constituents with differing views. The aim would be to fully understand the concerns of all constituents and establish whether the proposed new approach or a variant of it would be broadly supported among all classes of the Board's constituents.

ED 7 *Financial Instruments: Disclosures*

The Board considered an initial analysis of comment letters received on ED 7 *Financial Instruments: Disclosures*. The analysis identified the main themes arising in response to the questions in the Invitation to Comment.

The Board noted that the comment letters raised many issues other than those set out in the Invitation to Comment, each raised by a relatively small number of respondents. The Board agreed that these issues should be considered initially by a small group of Board members, and the results of that discussion be reported to the Board at a later date.

The Board was asked for its initial reactions to the comments received on the issues identified in the Invitation to Comment and to provide direction on which issues should be reconsidered in finalising the new Standard.

The Board tentatively:

- agreed to finalise an IFRS based on the proposals in ED 7.
- confirmed the proposals relating to disclosure of financial assets and financial liabilities and income statement amounts by IAS 39 categories, and of fee income and expense (parts (a), (b) and (d) of Question 1).
- confirmed the proposal to require sensitivity analysis, but asked the staff to develop more guidance on how to prepare such an analysis (Question 3)
- confirmed the proposals for the effective date, but agreed to amend the proposed exemption from presenting comparatives so that:
  - entities adopting IFRSs for the first time before 1 January 2006 that choose to adopt the new IFRS

before 1 January 2006 would be exempt from presenting comparative disclosures about the significance of financial instruments for financial position and performance.

  - all entities adopting the new IFRS before 1 January 2006 (rather than just first-time adopters) would be exempt from presenting comparative disclosures about the nature and extent of risk arising from financial instruments and about capital. However, such entities that are not first-time adopters would still need to present comparative disclosures about the significance of financial instruments for their financial position and performance. (Question 5)

- confirmed that the disclosures required by the new IFRS would be part of the financial statements. In addition the Board agreed to clarify that entities that are required by other authorities to provide similar information in a document physically distinct from the financial statements may include this information in the financial statements by cross-reference (Question 6).
- agreed to consider further the following proposed requirements at a future meeting:
  - disclosures about an allowance account (part (c) of Question 1).
  - disclosures about the fair value of collateral (Question 2).
  - capital disclosures (Question 4).
  - disclosure about financial liabilities at fair value through profit or loss.
  - the changes to be made to IFRS 4, and whether to make it consistent with the new IFRS (Question 7).
- agreed to seek the Financial Activities Advisory Committee's input about the extent to which the Board should provide implementation guidance and examples (Question 8).
- confirmed that the Board will not create bank-specific disclosure requirements.
- confirmed that the Board will not give exemptions from the general requirements of the new IFRS for subsidiaries.
- noted that any differential treatments for small and medium-sized entities (SMEs) will be considered in the SME project.
- agreed to clarify that the minimum disclosures proposed in the Exposure Draft are subject to the materiality requirements in IAS 1.

Business Combinations Phase II – Purchase Method Procedures

Drafting issues for the joint IASB-FASB Business Combinations Exposure Draft

The Board continued discussing issues from the November meeting that were identified in developing the joint FASB-IASB Business Combinations Exposure Draft. The FASB had discussed those issues at its meeting on 24 November.

At its meeting in November, the Board indicated a preference to develop with the FASB a new converged definition of a business combination if it could be done expeditiously and not delay publication of the joint Exposure Draft. Because a new definition of a business combination could not be developed expeditiously, the Board reaffirmed its decision to converge with the FASB's definition of a business combination for the purposes of the Exposure Draft. That definition is "a transaction or other event in which an acquirer obtains control of one or more businesses".

The Board reaffirmed the decision it made at the November meeting to converge the guidance for identifying the acquirer in IFRS 3 *Business Combinations* and SFAS 141 *Business Combinations*. It also agreed with the proposed guidance that was developed by the staff and agreed to by the FASB at its meeting on 24 November. The approach for converging the guidance is as follows:

- *The first step would be to identify the party who obtained control*—Neither Board would provide any control guidance in the joint Exposure Draft. The IASB's Exposure Draft would refer to IAS 27 and the FASB's Exposure Draft would refer to its literature providing guidance on control.
- *If it is not obvious which party obtained control, the second step would be to consider other factors*—These factors would be similar to the factors provided in both IFRS 3 and SFAS 141.

The Board decided to amend the definition of goodwill in IFRS 3, as follows (marked for ~~deletion~~):

> "Goodwill is future economic benefits arising from assets that are not ~~capable of being~~ individually identified and separately recognised."

At its 24 November meeting, the FASB agreed to converge on this definition.

Incorporation of EITF guidance into the joint Exposure Draft

The Board considered whether to incorporate the guidance in the two following EITF Issues into the application guidance in the joint Exposure Draft:

- EITF 95-8 *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in Purchase Business Combination*.
- EITF 04-1 *Accounting for Pre-existing Relationships between the Parties to a Business Combination*.

The FASB has decided to incorporate that guidance in the joint Exposure Draft. The FASB believes that the guidance in those issues is consistent with the decisions reached by the IASB and the FASB in phase II.

The Board agreed with the FASB's conclusion that the guidance in EITF 95-8 is consistent with the Boards' decision about which assets and liabilities should be part of the business combination accounting. The Board decided to incorporate concisely the guidance in EITF 95-8 into the application guidance in the joint Exposure Draft.

The Board also considered the issues addressed by EITF 04-01 and the conclusions it reached.

Specifically, the Board considered whether a business combination between two parties that have a pre-existing relationship should be evaluated to determine if the settlement of a pre-existing relationship is settled as a result of the business combination. The Board agreed with the EITF that such an evaluation needs to be made. The Board also agreed with the EITF that such a business combination is a multiple-element transaction with one element being the business combination and the other element being the settlement of the pre-existing relationship. The settlement should be accounted for separately from the business combination.

The Board then considered how a gain or loss arising from settlement of an executory contract in a business combination should be measured. The Board agreed with the EITF conclusion that the gain or loss should be measured at the lesser of:

- the amount by which the contract is favourable or unfavourable from the perspective of the acquirer when compared with market transactions for the same or similar items.
- any settlement provisions in the contract available to the party to which the contract is unfavourable.

The balance of the transaction price relates to the business combination.

To the extent that a contractual settlement amount is less than the amount by which the contract is favourable or unfavourable, the difference should be included as part of the business combination.

The Board also considered whether the acquisition of a right (referred to as a "reacquired right") that the acquirer had previously granted to the acquiree to use the acquirer's recognised or unrecognised intangible assets should be included in the measurement of the gain or loss on settlement, or as part of the business combination. The Board agreed with the EITF's conclusion that the acquisition of such a right should be included as part of the business combination. This could include, for example, rights to the acquirer's trade name under a franchise agreement or rights to the acquirer's technology under a technology licensing agreement.

The Board then considered whether the reacquired right meets the criteria for recognition separately from goodwill. The Board requested that the staff explore further the subsequent accounting for the reacquired right if that right is recognised as an intangible asset separately from goodwill.

The Board decided to require the following disclosures for business combinations between parties with a pre-existing relationship:

- The nature of the pre-existing relationship.
- The measurement of the settlement amount of the pre-existing relationship, if any, and the valuation method used to determine the settlement amount.
- The amount of any settlement gain or loss recognised and its classification in the statement of income.

These decisions incorporate the guidance in EITF 04-1 into the application guidance in the joint Exposure Draft subject to further consideration of subsequent accounting for the reacquired right if that right is recognised as an intangible asset separately from goodwill.

IAS 37 – Amendments: Measuring termination benefits

The Board discussed its proposed amendments to the requirements for termination benefits in IAS 19 *Employee Benefits*. These amendments will accompany the proposed amendments to the accounting for restructuring costs in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (details of which can be found in the project summary on the IASB Website).

The Board had previously decided to amend the recognition requirements in IAS 19 to converge with the requirements for (i) special termination benefits in SFAS 88 *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and (ii) one-time termination benefits in SFAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*. Accordingly, the Board will propose that:

- benefits for voluntary termination should be recognised when the employees accept the entity's offer of the benefits.
- benefits for involuntary termination should be recognised when the entity communicates its plan of termination to the affected employees and the plan meets specified criteria. However, if the benefits are provided in exchange for the employees' future services, the benefits should be recognised over the future service period.

The Board reconsidered the measurement of termination benefits. The Board decided to retain the existing measurement requirement in IAS 19 - termination benefits due more than 12 months after the balance sheet date should be discounted at a rate determined by reference to market yields on high quality corporate bonds. The Board also decided:

- to specify that when termination benefits are due more than 12 months after the balance sheet date, an entity should subsequently follow the recognition and measurement requirements in IAS 19 for post-employment benefits.
- to clarify that when termination benefits are provided through a post-employment benefit plan, the liability and expense recognised initially include only the value of the additional benefits that arises from the providing those termination benefits.

Revenue Recognition

The Board discussed whether, in concept, revenue might arise at contract generation in fully prepaid contracts and, if so, the conceptual reliability threshold that should apply to recognition of that revenue. The Board tentatively decided that:

- the staff should continue to develop the proposed conceptual approach to revenue recognition for the Board's future deliberation.
- in the context of fully prepaid contracts, an increase in net assets that occurs at contract generation gives rise to revenue that should be recognised if it can be measured reliably. The Board noted that the selection of a measurement attribute for performance obligations determines whether an increase in net assets has occurred at contract generation, and that the Board was yet to determine what that measurement attribute should be.
- the reliability threshold for estimates affecting revenue should be the same as the reliability threshold for other estimates affecting profits. The Discussion Paper (Preliminary Views document) on revenue recognition should describe alternative reliability thresholds considered by the IASB and the FASB, and explain the problems that applying any of those thresholds would create.

The Board will discuss revenue recognition in contracts that are not fully prepaid at future meetings.

Small and Medium-sized Entities (SMEs)

The staff reviewed the progress of the project since September 2003.

The staff then presented a summary of the 117 responses to the Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities*. Respondents to the Discussion Paper overwhelmingly supported an IASB project to develop a separate set of SME Standards. Many respondents expressed concern that if the IASB did not move ahead on this project quickly, jurisdictions around the world would develop their own SME reporting regimes that were likely to be inconsistent with each other, inconsistent with IFRSs and the

IASB *Framework*, not necessarily based on user needs, and costly.

The observer notes posted on the IASB's Website for the December 2004 meeting include an analysis of the responses question by question:
http://www.iasb.org/meetings/0412ob.asp

In October 2004, the Chairman of the IASB appointed a subcommittee of the Board to consider the best way forward, and present its views to the Board. The subcommittee's recommendations were presented to the Board by the Chair of the subcommittee. The principal recommendations of the subcommittee are:

- the responses to the Discussion Paper showed a clear demand for IASB SME Standards. The Board should remain committed to this project and should develop an exposure draft of SME Standards as the next step.
- IASB Standards for SMEs should focus on financial reporting by those non-publicly accountable entities that have external users of their financial statements (ie users other than primarily owner-managers). Jurisdictions could, of course, choose to permit or require them for all SMEs.
- The IASB should not develop detailed guidelines on which entities should or should not be eligible to use the IASB Standards for SMEs. That is a matter to be decided by national jurisdictions. However, the Board would indicate those entities for which the Standards for SMEs were not appropriate and any such entities using the SME Standards would not be able to assert that their financial statements were prepared in accordance with IFRSs.
- The Board should consider recognition and measurement simplifications for SMEs, as well as disclosure and presentation simplifications – based on user needs and cost-benefit considerations as provided for in the IASB *Framework*. There should be no preconceived objections to such changes. However, any modifications to recognition and measurement principles should be consistent with the IASB *Framework* and – as provided in the *Framework* – may be justified on the basis of user needs and cost-benefit considerations.
- If a recognition or measurement issue is addressed in an IFRS, but not in SME Standards, the entity should be required to apply that IFRS to the issue. This 'mandatory fallback' should be implemented by including IFRSs at the top of the accounting policy hierarchy in the SME equivalent of IAS 8 paragraph 11.
- An entity following IASB Standards for SMEs should follow those standards in their entirety and should not have a choice of reverting to IFRSs on a standard-by-standard or principle-by-principle basis.
- IASB SME standards should be organised topically, such as in balance sheet and income statement order, rather than having an equivalent SME standard for each IAS and IFRS number. However, the topical standards would be cross-references to the equivalent IAS/IFRS.
- The composition of the Advisory Group should be reviewed. Users of SME financial statements should be added to the group, as well as representatives of preparers and credit analysts.

After discussion, the Board accepted the subcommittee's recommendations as an appropriate way forward The Board asked the staff to continue to develop Standards for SMEs based on this approach. The Board also asked the staff to develop a project plan that includes round table meetings with preparers and users of SME financial statements.

IFRIC matters

The Board received a report on the International Financial Reporting Interpretations Committee's (IFRIC) meeting on 2 and 3 December. The report noted that since November the IFRIC had completed five Interpretations,[1] two exposure drafts[2] and had reached conclusions on three forthcoming draft Interpretations on service concessions. The IFRIC had also completed its review of its own operations and its report would be provided to the Board and Trustees shortly.

The Chairman of the IFRIC complimented the IFRIC on what it had achieved in 2004, especially during a very busy final six months.

EFRAG Discussions

The Chairman of the IFRIC also reported on discussions of the ten IFRIC projects mentioned above. The European Financial Reporting Advisory Group (EFRAG) had not raised significant concerns with nine of the projects. However, in relation to IFRIC 3, the EFRAG seemed unlikely to recommend endorsement (the EFRAG has further process to complete before finalising its views).

The EFRAG's concerns with IFRIC 3 related mainly to the perceived mismatch between the measurement of emission allowances (as required by IAS 38 *Intangible Assets*) and the measurement of the liability for emissions (as required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). Some EFRAG members did not accept that any asset or liability needed to be recognised unless there was a net liability (that is, not until the emissions value of liabilities exceeded the value of allowances held). Others accepted that assets and liabilities existed, but viewed the differences in their measurement as unacceptable. Others believed that accounting for the assets and liabilities should be required only if the assets were traded.

The Board noted that none of these concerns called the IFRIC's conclusions about how IFRSs apply to emission rights into question. Meeting the EFRAG's concerns would require changes to existing Standards.

Another view expressed by the EFRAG was that the IFRIC should have permitted allowances to be recognised at nil in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. The Board and the IFRIC had ruled out this option because it was inappropriate for an asset that could be traded and which could be held by the entity as a result of either a grant or purchase. The Board noted that IAS 38 and IAS 20 are to be reviewed, as previously reported, and those reviews may lead to consequential amendments to IFRIC 3.

The Board concluded that no further work on IFRIC 3 was justified by the concerns raised at EFRAG. They did not call into question that the Interpretation was correct.

IAS 1 *Presentation of Financial Statements*

The IFRIC indicated that it did not favour developing an Interpretation limited to bringing forward the following point from the Basis for Conclusions for IAS 1:

[1] IFRIC *Amendment to SIC-12 Consolidation--Special Purpose Entities*
IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*
IFRIC 3 *Emission Rights*
IFRIC 4 *Determining whether an Arrangement contains a Lease*
IFRIC 5 *Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds*

[2] IFRIC D10 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*
IFRIC D11 *Changes in Contributions to Employee Share Purchase Plans*

It would be inappropriate to exclude from the results of operating activities, if disclosed, items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount.

The Board noted the IFRIC's concern that such an Interpretation would be unlikely to limit entities' discretion in determining which items of expense are normally included in the results of operating activities. In addition, it would not prohibit the following practices:

- reporting subtotals in the income statement for the 'results of operating activities before … (particular items)' and then highlighting those subtotals in other reports.
- inappropriate classification of expenses in the analysis of expenses, such as omitting items from the functional classifications to which they belong.

The Board agreed that these concerns could not be overcome before they are considered within the Performance Reporting project.

Service Concessions

The Board was informed that staff were processing agreed amendments and edits in three exposure drafts of interpretations on service concessions, and preparing illustrative examples. The Chairman of the IFRIC reported that some had suggested that existing practices should be 'grand-fathered' in 2005, perhaps in the manner established for extractive activities. The Board decided not to pursue such an approach.

Meeting dates: 2005

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

2005

18—21 January

10 and 11†; 14—18 February

14—18 March

18—22 April (joint with FASB)

16—20 May

20—24; 27 and 28† June

18—22 July

19—23 September

17—21 October (joint with FASB), Norwalk, Connecticut, USA

10 and 11†; 14—18 November

12—16 December

† Includes a meeting with the Standards Advisory Council

