BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

July 2004

The International Accounting Standards Board met in London on 20-22 July 2004, when it discussed:

- Business combinations (phase II)
- Exploration for and evaluation of mineral resources
- Financial instruments
- Government grants
- Insurance contracts
- Joint ventures
- Revenue recognition
- Small and medium-sized entities

Business combinations

The Board reviewed all the decisions it has made in this project together with an overview of the issues for which the IASB and FASB have reached different conclusions in phases I and II of their Business Combinations projects.

Issues on which the IASB and FASB have reached different conclusions

Treatment of an overpayment

The issue the IASB considered is whether, in a business combination that is not an exchange of equal values, an excess of the consideration paid over the fair value of the acquirer's interest in the business acquired (ie any overpayment) should be recognised in profit or loss at the acquisition date.

The FASB had previously observed the difficulty of identifying and measuring the amount of any such overpayments and decided to retain the decision reflected in SFAS 141 *Business Combinations* that any overpayment should be subsumed in goodwill. In contrast, the IASB previously decided that any overpayment should be recognised in profit or loss at the acquisition date.

In considering the issue the IASB noted that conceptually any overpayment should be recognised in profit or loss at the acquisition date. However, it agreed with the FASB that in some circumstances it might be difficult to estimate the overpayment reliably. The IASB decided to ask the FASB to reconsider this issue with the objective achieving a decision converged with the IASB's view. The IASB also decided that if the FASB is unable to modify its decision, the Boards should expose the FASB's decision. In either case, the Boards, in the Invitation to Comment, will seek views on the reliability of identifying and measuring any overpayment.

Rebuttable presumption that consideration provides the best evidence of the fair value of the business acquired

The IASB had previously decided to adopt a rebuttable presumption that the fair value of the consideration given by the acquirer for its interest in the business provides the best basis for measuring the fair value of that business, even if the acquirer does not obtain control of all the ownership interests in the business.

The FASB did not adopt an equivalent presumption. It had previously decided that the fair value of the total consideration exchanged is *generally* more clearly evident when the business combination involves the purchase of all the acquiree's ownership interests and *normally* provides the best basis for measuring the fair value of the business acquired in a purchase of less than 100 per cent ownership interest.

At this meeting the IASB decided to remove the rebuttable presumption and adopt the FASB's wording.

Application guidance on the definition of a business

The definition of a business is not a convergence issue because the Boards decided to adopt the same definition. However, the extent of application guidance provided by each Board differs. The FASB decided to include more detailed application guidance than the IASB. However, the Boards had also previously decided that their Exposure Drafts for this joint project should as far as possible use identical style and wording. Therefore, the IASB considered whether it should adopt the more detailed application guidance of the FASB.

Recently, the FASB decided to clarify the definition of a business as follows:

- the definition of a business was clarified to emphasise that the assessment is based on the current capability of the acquired set.
- revised the description of inputs, processes applied to inputs, and outputs and clarified that the first two of those three elements are required in order for an acquired set of activities and assets to be regarded as a business (and affirmed that outputs are not required). However, the FASB noted that it is not essential that the set should have all forms of inputs or all forms of processes applied to those inputs that are or will be used to create outputs.
- eliminated the requirement to assess whether a missing element is minor and the related guidance and examples.
- clarified that the determination of whether a particular set of assets and activities is a business is based on whether the set is capable of being conducted and managed as a business by any willing acquirer.
- added application guidance stating that an acquired set of activities and assets would be presumed to be a business if the going concern element of goodwill is present in the set.

The IASB observed that the FASB had addressed the IASB's concerns about the FASB's previous version of the

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Business combinations (phase II) *(continued)*

definition and accompanying application guidance. The IASB also concluded that the FASB's revised application guidance could be useful in making a judgement whether the acquired set of activities and assets represent a business. Therefore, the IASB decided to include the FASB's revised application guidance in the IFRS.

Summary of decisions

The IASB considered a summary of its decisions in this project and decided to proceed with the decisions package for the purpose of drafting the Exposure Draft.

The IASB observed that the FASB and the IASB had agreed to develop jointly a common, cohesive Exposure Draft on accounting for business combinations that will incorporate the decisions reached in their joint project and the guidance in their existing Business Combinations standards that will not be changed by the joint project. (That guidance was developed in the Boards' separate phase I projects that led to US SFAS 141 *Business Combinations* and IFRS 3 *Business Combinations*.) The Boards expect that the guidance in the Exposure Drafts issued by the IASB and the FASB will differ only to the extent of differing decisions reached in phase I and the joint project and 'inherited' differences that originate from other Standards.

Exploration for and evaluation of mineral resources

The Board continued its redeliberation of ED 6 *Exploration for and Evaluation of Mineral Resources*, published for public comment in January 2004. The comment period for the Exposure Draft closed on 16 April 2004 and 54 comment letters were received. These comment letters are available on the Board's Website, *www.iasb.org*.

Impairment of exploration and evaluation assets

The Board reaffirmed its decision made in June 2004 that in principle IAS 36 *Impairment of Assets* should apply to exploration and evaluation assets. However, it decided to modify the recognition of impairment with respect to exploration and evaluation assets. The Board was persuaded by comments received from constituents. These constituents argued that applying IAS 36's requirements to assets for which there were insufficient data to make a proper, informed assessment of recoverable amount would lead to recognising impairment losses almost immediately. Therefore, the Board decided that an entity should assess an exploration and evaluation asset for impairment when specific facts and circumstances indicate that the carrying amount of such an asset exceeds its recoverable amount. In such circumstances, IAS 36 would be applied with respect to measurement, presentation and disclosure.

The Board considered a staff recommendation that it should eliminate the special cash-generating unit for exploration and evaluation assets proposed in ED 6. This would require all entities recognising exploration and evaluation assets to test those assets for impairment using CGUs defined by IAS 36. The Board's intention when it developed the impairment test in ED 6 was that entities would be able to test impairment at the level of the cost centre for extractive activities. Some respondents to ED 6 stated that the Board had not achieved its intention in this respect, and many preferred to apply IAS 36 without the special CGU.

The Board expressed concern that requiring entities to use IAS 36 CGUs would force entities recognising exploration assets to test for impairment at a very low level. IAS 36 paragraph 22 requires impairment to be assessed at the individual asset level 'unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets.' In some cases in which exploration and evaluation assets are recognised, eg in the petroleum sector, each well is capable of producing cash inflows that are observable and capable of reliable measurement because there is an active market for crude oil. The Board was concerned that respondents might not have been aware of this (because of a lack of familiarity with IAS 36) and directed the staff to investigate this further and to post on the IASB's Website a summary of the Board's concern and to invite comment from constituents on this issue. The Board will reconsider this issue in September.

Effective date and transition

The Board decided that the IFRS should apply to annual periods beginning on or after 1 January 2006 with earlier application encouraged, rather than 1 January 2005 as proposed in ED 6.

In addition, the Board decided to provide transitional relief such that entities adopting the IFRS early would not be required to provide comparative amounts for disclosures required by the IFRS in the first year of adoption. This transitional relief is similar to that proposed in ED 7 *Financial Instruments: Disclosures* published in July 2004.

Next steps

The staff will prepare a pre-ballot draft of the IFRS for comment by the Board. At its meeting in September, the Board will discuss the issue of the level at which impairment is assessed, in addition to any other issues arising from the review of the pre-ballot draft. The IFRS is expected to be issued in the fourth quarter of 2004.

Financial instruments

Financial instruments puttable at fair value

The Board discussed the classification as liabilities or equity of financial instruments puttable at a pro rata share of the fair value of the residual interest in the issuer ('financial instruments puttable at fair value'). IAS 32 *Financial Instruments: Presentation and Disclosure* requires such instruments to be classified as liabilities and IAS 39 *Financial Instruments: Recognition and Measurement* requires them to be measured at settlement amount (fair value) with changes in that amount recognised in profit or loss. This may result in apparently anomalous accounting: assuming that the fair value of the entity is higher than the carrying amount of its net assets (excluding the puttable instruments), the balance sheet will always show net liabilities and those net liabilities will increase the better the entity performs.

The Board discussed the following four possible approaches to this issue:

- amend IAS 32 to provide an exception so that instruments puttable at fair value are classified as equity;

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- continue to classify such instruments as liabilities but amend IAS 39 so that changes in their fair value would not be recognised;
- amend IAS 32 so that all puttable instruments (not only those puttable at fair value) would be separated into a put option and a host instrument; and
- do nothing.

The Board tentatively decided to consider further the first approach. The Board directed the staff to prepare a possible draft amendment to IAS 32 for consideration at a future meeting. This amendment would be intended to propose a limited exception so that only a tightly specified category of instruments puttable at fair value would be classified as equity.

Government grants

In February 2004, the Board tentatively decided to amend IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* by applying the accounting model for government grants contained in IAS 41 *Agriculture* to all government grants. (At present, the model in IAS 41 applies only to biological assets measured at fair value less estimated point-of-sale costs and grants that require entities not to engage in specified agricultural activity.)

At this meeting, the Board discussed some issues that arose from incorporating into IAS 20 the IAS 41 model.

IAS 41 distinguishes between unconditional and conditional grants. An unconditional grant is recognised as income when the grant becomes receivable; a conditional grant when the condition is satisfied. IAS 41, however, contains little guidance about what is meant by unconditional or conditional in this context. Therefore the Board decided to define a condition for the purposes of revised IAS 20 as a stipulation that entitles government to the return of the granted resources if a specified event either occurs or does not occur. The Board also noted that any such stipulation should have commercial substance to be regarded as a condition.

IAS 41 specifies when a government grant is recognised as income. It does not specify when the transfer of resources from government is recognised. Therefore, the Board decided to specify that an entity should recognise a government grant as an asset at the earlier of (i) having an unconditional right to receive the government grant (regardless of whether there are conditions attached to retaining the grant) and (ii) receiving the government grant. The Board decided that if the grant involves government waiving repayment of all or part of a liability, the reduction in liability should be recognised when the liability is discharged or cancelled.

A government grant is defined in IAS 20 as a transfer of resources "in return for past or future compliance with certain conditions relating to the operating activities of the entity". The Board observed that in an accounting model that distinguishes between conditional and unconditional grants, the use of the word 'conditions' in this definition could be confusing. Therefore, the Board decided to delete the phrase "in return for past or future compliance with certain conditions relating to the operating activities of the entity" from the definition of a government grant. The Board also decided to provide additional guidance in the amended Standard to clarify which transactions with government meet the definition of a grant.

IAS 20 explains that loans at nil or low interest rates are forms of government assistance, but the benefit of the reduced loan is not treated as a government grant. Similarly, a government may guarantee an entity's borrowing, but IAS 20 does not treat the benefit of the guarantee as a government grant. The Board noted that these requirements of IAS 20 conflict with IAS 39 *Financial Instruments: Recognition and Measurement* because IAS 39 requires financial liabilities to be measured initially at fair value. Therefore, the Board decided to delete the references to loans at nil or low interest rates and guarantees from paragraphs 35 and 37 of IAS 20.

The Board decided that entities that receive a government grant in connection with the acquisition of an asset should be required to test that asset for impairment in accordance with IAS 36 *Impairment of Assets* on its initial recognition. The Board also decided to clarify that any recognised liability arising from conditions attaching to the grant should be included in the same cash-generating unit as the acquired asset.

Lastly, the Board considered transition requirements for the amendments to IAS 20. The Board decided to propose retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, it decided to ask constituents to provide details of circumstances in which this requirement would cause difficulties.

Insurance

In November 2003, the Board discussed how to reactivate phase II of the project on insurance contracts, which has been dormant since January 2003. Before restarting phase II, the Board is assembling a small working group of senior insurance professionals to help it analyse the issues. The Board hopes to announce the composition of the working group shortly and to schedule the first meeting of the working group in September.

At this meeting, as preliminary preparation, the Board discussed general educational material on the nature of insurance contracts and current accounting models for insurance contracts. The material illustrates some of the accounting questions that phase II will need to consider, but does not attempt to evaluate possible approaches and makes no recommendations. No decisions were made. The Board expects to continue its discussion of this material in September.

Joint ventures

The Board considered the most appropriate way to progress a short-term project on the accounting for interests in joint ventures with the objective of achieving convergence in the accounting for interests in jointly controlled entities.

In April 2003, the Board asked the Australian Accounting Standards Board to take responsibility for a broad long-term research project on joint venture arrangements. In response to this, the AASB formed a Joint Ventures research project team ('the research team'), comprising staff from the standard-setters in Australia, China/Hong Kong, Malaysia and New Zealand. The research team met for the first time in February 2004, and developed a research project proposal. That proposal, which was presented at the National Standard-setters meeting in April 2004, outlined recommendations for the research project's scope, the research methods to be used (including a draft questionnaire), and the research timetable.

After considering the research team's project proposal at the National Standard-setters meeting in April 2004, the IASB asked the AASB to divide the project into two parts:

- a short-term project with the objective of achieving convergence in the accounting for interests in jointly controlled entities by removing the option from IAS 31 of accounting for interests in jointly controlled entities using either the equity method or proportionate consolidation.
- a longer-term research project dealing with the issues identified in the research team's project proposal. It was

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agreed that the National Standard-setters would assist the AASB in this longer-term project by 'field testing' the questionnaire.

At this meeting, the Board expressed concern about whether the short-term convergence project could be done without the research project having been completed. Deciding on whether to retain the option to use the equity method or proportionate consolidation would depend on a proper understanding of the nature of interests in joint ventures, including the substantive differences between an interest in a jointly controlled entity and an undivided interest in an asset or group of assets. Board members thought it was unlikely this could be achieved without conducting in-depth research on issues such as the structure of joint ventures, the effect of legal form on the substance of an arrangement and the concept of joint control.

The Board did not decide whether to proceed with the short-term convergence project. However, it did decide that if it *were* to continue the project, the IASB/FASB joint convergence project team would be best placed to carry it out. Instead, the Board agreed:

- in accordance with its earlier conclusions on the conduct of all research projects, to discuss issues with the research team at Board meetings as needed to progress the longer-term project. The Board also decided to ask the AASB to reconsider the timetable for the research project presented at the April 2004 National Standard-setters meeting to see whether it could be accelerated in light of this availability of time at regular Board meetings.
- the staff should prepare an analysis:
    - outlining the issues that would need to be addressed in a short-term project whose objective is to eliminate from IAS 31 the option of accounting for interests in jointly controlled entities using either the equity method or proportionate consolidation; and
    - examining whether those issues could be resolved in a reasonable time.

Classification of liabilities

The FASB has been considering the classification of liabilities as current or non-current when a liability has been refinanced after the balance sheet date or a waiver of a breach of covenant has been agreed after the balance sheet date. The FASB had previously tentatively agreed with the requirements of IAS 1 *Presentation of Financial Statements* (as revised in 2003) for classification of these liabilities. However the FASB has now decided to defer the publication of its exposure draft on these issues and instead to consider them as part of phase II of its project on financial performance reporting by business enterprises.

The Board noted the concerns underlying the FASB decision, which were cost-benefit concerns associated with FASB constituent groups. In particular, constituents were concerned that most non-public entities do not prepare interim financial statements with sufficient specificity for covenant violations to be forecast and therefore could not clear them before the balance sheet date. The Board decided not to reconsider the requirements of IAS 1 but asked the staff on the SME project to develop an analysis of the issues for consideration in that project.

Revenue recognition

The Board continued its discussion of how to measure the fair value of a contractual obligation to a customer. At previous board meetings, some FASB and IASB members had supported basing the fair value of obligations to customers on the customer consideration amount. Some of these FASB and IASB members had adopted the perspective of a customer in identifying the activities the reporting entity performs in return for the customer's consideration.

The Board considered case studies (available in the observer notes for this meeting) illustrating the implications of adopting a customer perspective, and tentatively decided that accounting for contractual obligations in the manner illustrated would be inappropriate. The case studies included examples of when an entity legally lays off all of its customer obligations immediately after contracting with its customers, and pays the assuming party less than the customers paid it. The Board tentatively decided that in those circumstances, the assuming party should not measure the fair value of the obligations it assumes at the amount paid by the customers. The Board also tentatively decided that the fair values of identical obligations assumed in different markets (retail and business-to-business) should not differ, even if the consideration received by the reporting entity differs.

The Board also considered a case study illustrating how the proposed conceptual model for accounting for contractual rights and obligations could be applied to a long-term construction contract. The Board tentatively decided that applying the proposed conceptual model accounts appropriately for the contract under the assumed facts, which included full prepayment by the customer at contract inception. The Board expressed concern about whether revenue from contract origination (also called selling revenue) might be measured at an amount different from an observable market price for the contract as a whole, if it exists. This issue will be addressed in a forthcoming board paper on accounting for wholly and partially executory contracts.

Financial reporting standards for small and medium-sized entities

The Board discussed draft SME versions of the IASB *Framework for the Preparation and Presentation of Financial Statements* and of three standards:

- IAS 16 *Property, Plant and Equipment*
- IAS 18 *Revenue*
- IAS 23 *Borrowing Costs*

As with previous discussions of other draft SME versions of IFRSs, the Board's discussion was preliminary and no decisions were made. Decisions on the content of IASB Standards for SMEs will be made only after the Board has considered the responses to the Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities*.

Draft SME version of the *Framework*. Staff presented to the Board an extraction of the principles from the IASB *Framework* in the form of an IASB Framework for SMEs. The Board expressed concern that the extraction might be regarded as creating a Framework for SMEs different from the one that applies to entities following IFRSs. The Board decided that it should wait to review the responses to the Discussion Paper before concluding whether a special version of the *Framework* is appropriate for SMEs.

Draft SME version of IAS 16. The SME version of IAS 16 includes no discussion of the revaluation model but has a

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reference to IAS 16 if an SME adopts that model rather than the cost model. The Board did not disagree with this approach.

The Board noted that some of the grey letter guidance in IAS 16 that was omitted in the draft SME version would be particularly useful to an SME. Examples include the initial costs to be included as part of the cost of an item of property, plant and equipment; component depreciation; and when depreciation should begin and cease. Staff will review the deleted guidance and will develop a revised standard with some guidance reinstated, perhaps as an appendix of application guidance rather than in the body of the SME standard. The Board also suggested that the staff consider a similar approach (application guidance and examples in an appendix) for other SME standards.

Draft SME version of IAS 18. All of the principles in IAS 18 are included in the draft SME version of that standard except that the detailed guidance on exchanges of goods and services in paragraph 12 of IAS 18 is replaced with a reference back to IAS 18. Also, several disclosures are not included. The Board noted that revenue recognition is a pervasive issue for SMEs, and most of the guidance in IAS 18 should be retained in the SME version of that standard.

Draft SME version of IAS 23. IAS 23 was not revised in the recent Improvements Project. It permits an entity an accounting policy choice of expensing or capitalising interest. The SME version of IAS 23 retains the choice but does not include any discussion of the capitalisation model. Instead, there is a reference back to IAS 23 if an SME wishes to choose capitalisation. The SME version of IAS 23 describes the choice as the "expense model" and the "capitalisation model" rather than the "benchmark" and "allowed alternative". The Board did not disagree with this approach.

Project plan. The Board also discussed a project plan proposed by the staff and made some modifications to it. Under the plan tentatively supported by the Board:

- The Board will have reviewed the SME version of all IASs and IFRSs and the *Framework* by December 2004, in most cases at more than one Board meeting. However, the views expressed in the comment letters on the Discussion Paper may result in a change to this timetable.
- An SME version of IAS 26 *Accounting and Reporting by Retirement Benefit Plans* is not needed because such plans have a fiduciary responsibility to their participants and, therefore, have public accountability. They must use IFRSs, not SME standards.
- Staff will consider whether to bring to the Board SME versions of Interpretations or to incorporate them into the SME standards.
- The Board will begin its consideration of the comments received on the Discussion Paper at the meeting in October 2004. Consideration would continue in November and, if necessary, December 2004.
- If the responses to the Discussion Paper do not result in major alterations to the Board's approach to the project, in January 2005 the staff will bring to the Board an initial combined document reflecting a proposed exposure draft of IASB Standards for SMEs. Deliberation of that document would continue during the first half of 2005, with a goal of approval of an exposure draft by 30 June 2005.
- The Board suggested that, after the exposure draft is published, the staff organise one or more round-table meetings with preparers, auditors, and users of SME financial statements to discuss their views about the exposure draft.

Announcement: IASB meeting week schedule

In September 2004 the Board will adopt a new schedule for its meetings designed to make better use of Board time. The revised schedule provides for greater interaction between Board members and the IASB staff as well as time for small group meetings with constituents. This new schedule will not be in effect for the October and November meetings (owing to the joint meeting with the FASB in October and the Standards Advisory Council meeting in November) but will be resumed in December.

There will be four half-day meetings: Tuesday 1300-1600; Wednesday and Thursday 1300-1800; and Friday 0800-1200. Holding meetings in the afternoons will enable FASB staff to participate in the Board's discussions on joint projects. Meeting early on Friday accommodates project teams in Japan, Australia and New Zealand.

In addition, a public 'educational session' with the Board will be held on Wednesday morning 0800-1200. This session will be used to provide background and education on difficult issues, to help the staff identify potential points of confusion or ideas for solutions. These sessions will consider issues to be discussed in subsequent months' meetings. No decisions will be made.

Tuesday and Thursday mornings are available for public meetings between the Board and outside groups. Should such meetings be scheduled, the details will be announced on the IASB's Website in the usual way.

Meeting dates: 2004

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

21—24; 27[§‡], 28[‡] September

18—20 October, Norwalk, Connecticut, USA

15—19 November[†]

14—17 December

† Includes a meeting with the Standards Advisory Council

‡ Includes meetings with partner standard-setters

§ Includes meetings with other national standard-setters

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