BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

March 2004

The International Accounting Standards Board met in London on 17-19 March 2004, when it discussed:

- Board priorities
- Business combinations
- Consolidation
- Disposal of non-current assets and presentation of discontinued operations
- Financial guarantees and credit insurance
- Financial instruments
- IAS 12 *Income Taxes*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IFRIC issues
- Post-employment benefits
- Reporting comprehensive income
- Revenue recognition
- Small and medium-sized entities

IAS 39 *Financial instruments: Recognition and Measurement*: the fair value option

In February 2004 the Board tentatively decided to propose an amendment to IAS 39 to limit the application of the fair value option to the following three situations.

(a) The item is a financial asset or financial liability that contains one or more embedded derivatives.

(b) The item is a financial liability whose amount is contractually linked to the performance of assets that are measured at fair value.

(c) The exposure to changes in the fair value of the financial asset or financial liability is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability, including a derivative.

In February, the Board also tentatively decided to add a fourth category for available-for-sale assets other than loans and receivables, but did not decide how this category should be defined.

At this meeting the Board considered various issues and made the following tentative decisions:

- The Board considered how to define the fourth category to which the option may be applied (ie available-for-sale assets other than loans or receivables). The Board tentatively decided that this category should include any available-for-sale financial asset (as defined in IAS 39) other than a loan or receivable, by irrevocable designation on initial recognition on an asset-by-asset basis.
- The Board considered whether the first category (ie financial instruments containing embedded derivatives) should apply only when the embedded derivative is required to be separated under IAS 39 or whether it should apply to all instruments containing embedded derivatives, regardless of whether IAS 39 requires the derivative to be separated. The Board tentatively decided that this category should include all instruments containing embedded derivatives, regardless of whether IAS 39 requires the derivative to be separated. However, the Board noted that many financial assets and financial liabilities contain embedded derivatives. Accordingly, it tentatively decided to ask a question in the invitation to comment accompanying the exposure draft about whether the category was too broad.
- The Board tentatively decided to clarify that the words “contractually linked” in the second category mean that the contract must specify the asset(s) to whose performance the holder is entitled.
- The Board considered whether to change the words “substantially offset” in the third category. The Board tentatively decided to retain these words, but to note in the basis for conclusions that an exact offset is not required.
- The Board considered whether the third category should apply only when either the financial asset or the financial liability is measured at fair value. The Board tentatively decided that the category should not be restricted in this way. It noted that in some countries (eg Denmark) there were entities that originate mortgages and fund them with long-term traded bonds whose terms closely match those of the mortgages. The Board decided that the fair value option should be available in such cases provided that the assets and liabilities meet the “substantially offset” test.
- The Board discussed the wording of a reference in the exposure draft about the powers that prudential supervisors have that are relevant to the determination of fair value. It tentatively agreed that this sentence should read as follows: “For entities subject to prudential supervision such as banks and insurance companies, the powers of the relevant prudential supervisor may include oversight of the application of [the requirements in IAS 39 on how to determine fair value] and of relevant risk management systems and policies.”
- The Board discussed what effective date and transitional provisions should be proposed. The Board tentatively decided that the exposure draft should propose that the revisions to the fair value option would apply for accounting periods

(continued)

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IAS 39 Financial instruments: Recognition and Measurement: the fair value option *(continued)*

beginning on or after 1 January 2005. If an entity applied the present version of the fair value option to earlier accounting periods, at the beginning of the accounting period it would be permitted to re-designate the instruments that the option when it first applies the new requirements. In the case of items to which the entity applied the previous version of the option and it does not apply the new version of the option, the fair value at the date the option ceases to be applied becomes the instrument's deemed cost. In all other respects, the new version of the option should be applied retrospectively (ie in the comparative financial statements instruments to which the option is applied should be accounted for using the option).

- The Board considered what questions to pose in the invitation to comment. The Board tentatively decided to include questions on whether respondents agree with the proposals in the exposure draft and, if not, how they would amend them. The Board also tentatively decided to include questions about the category for financial instruments that contain embedded derivatives (see above), the proposed effective date and transitional provisions (see above), and any other issues in relation to the changes proposed in the exposure draft.
- The Board tentatively decided that the exposure draft should have a 90-day comment period.

Board priorities

The Board discussed a staff paper that had been sent to the liaison national standard-setters (NSS) seeking their input on the Board's planning of its future agenda. The Board plans to meet jointly with the FASB in April 2004 and, as agreed in October 2003, the boards will be seeking to achieve further integration of their work programmes. Additionally, the boards will be meeting the other NSS in April to discuss this planning.

The staff asked the Board for input so that a joint IASB/FASB staff paper on priorities could be finalised for the April meetings. The Board will discuss priorities again before meeting the FASB and in the light of input from the NSS and the joint staff paper.

The staff paper made recommendations in relation to:

- the objectives for the April 2004 meeting;
- resource allocation;
- the integration of conceptual frameworks and priority projects for amendments to aspects of the IASB *Framework* and related standards;
- joint projects on standards;
- the short-term convergence project;
- future projects to be addressed through the research projects agenda; and,
- timing and sequencing of projects.

No decisions were made on these recommendations as the staff wanted to determine what additional information the Board needed to be able to address the planned joint staff paper in April.

Business Combinations (phase I)

In February Board members were provided with a pre-ballot draft of an Exposure Draft of Proposed Amendments to IFRS 3 *Business Combinations*[1]. The draft Exposure Draft proposed:

(a) to remove from IFRS 3 the scope exclusions for business combinations involving two or more mutual entities and business combinations in which separate entities are brought together to form a reporting entity by contract alone without the obtaining of an ownership interest. This includes combinations in which separate entities are brought together by contract to form a dual listed corporation.

(b) to require an acquirer to measure the cost of such a business combination as the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

(c) that no amendments should be made to the transitional and effective date requirements in IFRS 3.

At this meeting the Board considered five issues arising from reviews of the pre-ballot draft.

Clarifying the circumstances in which the cost of a business combination should be measured as the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

The Board confirmed that when the acquirer and acquiree in a business combination are both mutual entities and the combination involves no reliably measurable consideration in the form of assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree, the acquirer should measure the cost of the combination as the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

The Board then considered how the cost of a combination should be measured if the acquirer and acquiree are both mutual entities but the combination does involve some reliably measurable consideration in the form of assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in exchange for control of the acquiree. The Board unanimously agreed that, in such circumstances, the cost of the combination should be measured as the aggregate of:

- the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities; and
- the fair value, at the date of exchange, of the reliably measurable consideration. This amount would be recognised as goodwill.

Therefore, the acquirer would recognise goodwill equal in amount to the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed, or equity instruments issued by the acquirer in full or partial exchange for control of the acquiree.

Structuring transactions to avoid the recognition of goodwill

The Board considered whether it might be possible for entities to circumvent IFRS 3's normal purchase method principles and avoid the recognition of goodwill by structuring a business combination to be one in which separate entities are brought

[1] IFRS 3 is to be issued later in March 2004, together with revised versions of IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*.

together to form a reporting entity by contract alone. For example, assume entity A agrees to purchase from entity B one of B's subsidiaries, entity C. To assist A in its goal of avoiding the recognition of any goodwill on the transaction, B agrees to transfer to A, for no consideration, control of C but not its ownership interest in C. Then, at some later date, A acquires all of the non-controlling in C, being all of B's ownership interest in C.

The Board concluded that an entity would not, in an arm's length transaction, agree to transfer control, but not ownership, of a business to another entity without also entering into some form of legally enforceable agreement obliging that other entity at a later date either to acquire some or all of the ownership interest in the business, or to pay some form of consideration for the right to control the business. The notion of 'substance over form' and the guidance the Board is developing on linkage would require these two agreements to be considered together, thereby overcoming the possibility of abuse.

Therefore the Board agreed not to consider this issue further.

Costs directly attributable to a business combination

The Board decided to clarify in the Exposure Draft that when a business combination involves two or more mutual entities or is one in which separate entities are brought together to form a reporting entity by contract alone, any costs directly attributable to the combination should be recognised as an expense in profit or loss in the period in which they are incurred. Such costs might include professional fees paid to accountants, legal advisers, valuers and other consultants to effect the combination.

Transitional provisions and effective date

The Board decided that the exposure draft should propose any amendments to the transitional and effective date requirements in IFRS 3. This would have the following effects:

- entities would not be required to apply the amendment to IFRS 3 to the accounting for any business combinations for which the agreement date is before 31 March 2004 (ie the date IFRS 3 is to be issued). This would include any combinations in which the acquirer and acquiree are both mutual entities or in which separate entities or businesses are brought together to form a reporting entity by contract alone.
- entities would be permitted to apply the amendment to IFRS 3 from any date before 31 March 2004, provided: (1) the valuations and other information needed to apply the IFRS to past business combinations were obtained at the time those combinations were initially accounted for; and (2) the entity also applies IAS 36 Impairment of Assets (as revised in 2004) and IAS 38 Intangible Assets (as revised in 2004) prospectively from that same date, and the valuations and other information needed to apply those Standards from that date were previously obtained by the entity so that there is no need to determine estimates that would need to have been made at a prior date. Therefore, an entity that elects to apply the amended version of IFRS 3 from any date before 31 March 2004 would also be required to apply that amended version to any combination in which the acquirer and acquiree are both mutual entities or in which separate entities or businesses are brought together to form a reporting entity by contract alone, and for which the agreement date is after the date selected but before 31 March 2004.
- entities would be required to apply the amended version of IFRS 3 to the accounting for business combinations for which the agreement date is 31 March 2004 or later. Therefore, entities would be required to apply the amended version of IFRS 3 to restate any combinations in which the acquirer and acquiree are both mutual entities or in which separate entities or businesses are brought together to form a reporting entity by contract alone, and for which the agreement date is 31 March 2004 or later.

In deciding to propose no amendments to the transitional and effective date requirements in IFRS 3, the Board considered whether entities would have the fair value information needed to restate, in accordance with the proposed amendments to IFRS 3, combinations between 31 March 2004 and the date the amendments are effective. The Board noted that it had, in the past, rejected requiring restatement of past business combinations on the basis that it is likely to be impossible for many combinations—the information needed may not exist or may no longer be obtainable—and it would require the determination of estimates that would have been made at a prior date, and therefore raises problems in relation to the role of hindsight.

However, the Board also noted that the amendments to IFRS 3 are to be finalised before the end of 2004. Therefore, the period between 31 March 2004 and the date the amendments are effective should be relatively short. As a result:

- the information needed to restate combinations between 31 March 2004 and the date the amendments are effective *should* be obtainable, notwithstanding that it might not have been obtained at the time of initially accounting for the combination.
- any problems in relation to the role of hindsight should not be insurmountable given the relatively short period between the possible agreement date of such a combination and the date the amendments to IFRS 3 are finalised.

The Board concluded that these factors, combined with the benefits of improved comparability, mean that entities should be required to restate, in accordance with the proposed amendments to IFRS 3, those combinations between 31 March 2004 and the date the amendments are effective.

Comment period

The Board unanimously agreed that the Exposure Draft should have a 90-day comment period.

Consolidation (including special purpose entities)

The Board continued its discussion of the concept of control as the basis for consolidation.

The Board discussed the circumstances in which an entity currently dominating policy determination is able to satisfy the *power* criterion and tentatively decided the following:

- an entity with a current ability to determine strategic operating and financing policy meets the power criterion only in the absence of a third party able to dominate policy determination. For example, a significant minority shareholder that has been able to dominate policy determination can satisfy the power criterion if the balance of holdings is dispersed and disorganised, but not if the balance is held by a passive majority shareholder.
- An entity that does not dominate the determination of strategic operating and financing policy in practice, but that has the ability to dominate such determination, meets the power criterion. This is the case even if the entity has a history of not utilising its ability to dominate or has no current intention of utilising this ability.

The Board discussed how power should be assessed in the following circumstances. Entity A currently dominates policy determination. Entity B holds currently exercisable potential voting rights relevant to a current assessment of power[2]. On exercise, these potential voting rights would reduce entity A's ownership position and result in entity A having no assurance that it would be able to dominate policy determination. For example, entity A would not be the majority shareholder following exercise by entity B. However, entity B would not have the ability to dominate policy determination following exercise.

The Board tentatively decided that in this situation entity A would satisfy the power criterion. Although entity A may not be assured of a continued ability to dominate policy determination, it has a current ability to dominate policy determination and entity B is unable to dominate, so entity A satisfies the power criterion. However, if, taking into account its potential voting rights and all other sources of power available to entity B (such as existing holdings, contractual rights and holdings through de facto agents), entity B could dominate policy determination, entity A would not meet the power criterion. Entity A's ability to dominate policy determination can be effectively 'trumped' by entity B, so the power criterion is not satisfied.

For example, if entity A currently had a 51 per cent voting interest in an investee[3] and entity B had potential voting rights that would reduce entity A's holding to 40 per cent and entitle entity B to a holding of 21 per cent, entity A would meet the power criterion, provided the balance was dispersed. However, if entity A currently had a 51 per cent voting interest, entity B holds potential voting rights and other direct holdings and, after exercise, entity A's holding would be reduced to 30 per cent and entity B would have more than 50 per cent, entity B (rather than entity A) would meet the power criterion.

The Board then discussed whether the concept of Power should be explained in the future exposure draft in a step-by-step formulaic form or descriptively. The Board tentatively decided that the concept of power should be explained in a descriptive form accompanied by a flow chart. The flow chart would be used primarily to illustrate the interaction between actual domination of policy and the ability to determine policy as set at the beginning of this summary.

The Board also tentatively decided that the future exposure draft should not include rebuttable presumptions of power, but should include examples of scenarios in which the power criterion is satisfied.

Disposal of non-current assets and presentation of discontinued operations

The Board considered an issue that arose on the ballot draft of IFRS 5. Following decisions made in February 2004, the staff developed an example of a simple method of arriving at the amounts required to be presented in the income statement and balance sheet for a newly acquired subsidiary that met the criteria to be classified as held for sale. That simple method did not produce the amounts relating to assets held for sale and discontinued operations required to be disclosed in the notes. The Board (i) confirmed its decision that newly acquired subsidiaries that met the criteria to be classified as held for sale should be consolidated, and (ii) decided that the requirements for amounts to be disclosed in the notes relating to assets held for sale and discontinued operations should not apply to such subsidiaries.

Fair value hedge accounting for a portfolio hedge of interest rate risk

Sweep issues

The Board discussed three sweep issues that had arisen from comments on the pre-ballot draft.

The Board redebated an issue it had considered in its January 2004 meeting, namely whether to clarify that when prepayment estimates change because of factors other than interest rates, no ineffectiveness arises. It noted concerns that, in practice, it can be very difficult to determine whether or not a change in prepayment estimates results from movements in interest rates. Accordingly, the Board tentatively agreed to clarify that only changes in expected repricing dates that clearly arise from factors other than changes in the hedged interest rate, are uncorrelated with changes in the hedged interest rate and can be reliably separated from changes that are attributable to the hedged interest rate are to be excluded when measuring ineffectiveness. Furthermore, if there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

The Board revisited the tentative decisions it made at the February 2004 meeting that would clarify three matters in relation to designating a portion of a financial asset or financial liability as the hedged item. In particular it discussed whether a designated portion need have some relationship to the instrument being hedged and, if so, how close that relationship should be. The Board decided it could not resolve this issue in the time available (ie before the amendments to IAS 39 are issued later this month) and that the issue would be best addressed in conjunction with the FASB, with the aim of reducing differences between IAS 39 and the equivalent US Standard (FAS 133 *Accounting for Derivative Instruments and Hedging Activities*). Accordingly, the Board

- reconfirmed the decision it made in February to clarify that an entity cannot designate, as the hedged item, a portion of the cash flows on a financial asset or financial liability that is greater than the total cash flows of the asset or liability. Hence, if a liability has an effective interest rate of less than LIBOR, the entity cannot designate, as the hedged item, a 'portion' of the cash flows on the liability equal to the principal amount of the liability plus interest at LIBOR. The Board agreed to clarify, however, an entity can designate all of the cash flows on the entire liability as the hedged item and hedge them for changes in only one risk.
- tentatively agreed that the Standard should not, at this stage, provide any other guidance on hedging portions beyond that already contained in IAS 39 and the exposure draft on macro hedging. However, this issue should be the subject of a future convergence project to be given high priority.

The Board considered concerns that entities could 'game' the effectiveness requirements for a macro hedge, for example by using unrealistic estimates of future prepayments in order to reduce reported ineffectiveness. The Board noted it had decided to permit entities to use their own estimates so that the accounting treatment could be based on the information used for risk management purposes and hence, systems changes could be reduced. However, to meet these concerns it tentatively agreed to clarify that

[2] The circumstances when potential voting rights are relevant to a present assessment of power are yet to be determined.

[3] Or a significant minority shareholding and the balance of holdings is dispersed and disorganised.

- the designation and documentation of a macro hedge must specify the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured.
- these specified policies should be in accordance with the entity's risk management procedures and objectives.
- changes in policies should not be made arbitrarily. They should be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

The Board considered other comments raised on the pre-ballot draft and approved the staff's proposed resolution of them on an exceptions-only basis.

IAS 39 *Financial Instruments: Recognition and Measurement*: Other issues

The Board debated two other issues that had arisen on IAS 39.

Whether to give implementation guidance on how cash flow hedges may be presented in the balance sheet

Some of the Board's constituents have expressed concern that users of financial statements might misinterpret amounts reported in equity for cash flow hedges. To meet this concern, the Board tentatively agreed to add to the Implementation Guidance on IAS 39 three examples that illustrate how amounts reported in equity for cash flow hedges may be presented. It also tentatively agree to specify that, whatever presentation is adopted, it must:

(a) clearly show that amounts relating to cash flow hedges are part of equity and are not part of liabilities,

(b) not imply that amounts relating to cash flow hedges form a separate balance sheet category that is neither liabilities nor equity, and

(c) include amounts relating to cash flow hedges in the statement of changes in equity in accordance with paragraph 96(b) of IAS 1 *Presentation of Financial Statements.*

Proposals put forward by the European Banking Federation (FBE) for a new kind of hedge accounting for hedges of interest rate margin

The Board discussed a proposal for a new kind of hedge accounting proposal put forward by the FBE. In summary, the proposal is as follows.

(a) There would be a new kind of hedge accounting inserted into IAS 39 – in addition to fair value hedge accounting (including macro hedging) and cash flow hedge accounting – for hedges of interest rate margin.

(b) In a hedge of interest rate margin, the entity would designate as the hedged item a portfolio of assets and liabilities, accounted for at amortised cost. The hedging objective would be to reduce the potential variability of recognised (ie accrual accounted) interest margin that arises when interest rates change if the fixed (or floating) rate assets in the portfolio do not match the fixed (or floating) rate liabilities.

(c) The entity would also designate one or more derivatives (eg interest rate swaps) as the hedging instrument.

(d) To the extent that the designated derivative(s), when accrual accounted, have the effect of reducing variability of recognised interest rate margin, the hedge is effective.

(e) An effective hedge is accounted for as follows. In the income statement, both the hedging instrument (eg the interest rate swaps used to hedge) and the hedged item (ie the portfolio of assets and liabilities) are accounted for using the effective interest method. In addition, the hedging instrument is measured at fair value in the balance sheet and an equal and opposite liability (or asset) is reported in the balance sheet in an account called 'interest rate margin hedge'. For example, if the designated hedging instrument is a swap and its fair value increases from zero to CU100 (ie the swap is an asset), the entity would recognise both an asset of CU100 for the fair value of the swap and a liability of CU100 for 'interest rate margin hedge'.

The Board noted that the FBE proposes that this approach would be in addition to (and not a replacement of) the fair value hedge accounting and cash flow hedge accounting already permitted by IAS 39 and the proposed amendments for macro hedging.

The Board raised a number of concerns about the approach, the principal one being that it results in losses being recognised as assets and gains as liabilities. This breaches both the IASB *Framework* and one of the principles of hedge accounting set out in the material for the roundtable discussions held in March 2003. (For instance, in the above example in which the entity recognises a liability of CU100 for 'interest rate margin hedge', there is no liability as defined in the *Framework*.) The Board noted that this concern could be overcome if the amounts for 'interest rate margin hedge' were recognised in equity rather than as assets and liabilities. Representatives of the FBE have been asked to consider whether they would want the Board to pursue the approach if this change were made. The Board also noted that if this main concern were to be overcome, there are other points in the model that it would need to work on (for example, whether the effectiveness test is sufficiently rigorous). Finally, the Board noted that the approach, being a significant new approach, would need to be published as an exposure draft before it could be incorporated into IAS 39.

Financial guarantees and credit insurance

In February 2004, the Board directed the staff to prepare an exposure draft on contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument (for details, see *IASB Update*, February 2004). At this meeting, the Board decided that:

- the proposals in the exposure draft would apply to periods beginning on or after 1 January 2006, with earlier application encouraged.
- an entity adopting the proposals would apply them retrospectively.

The Board indicated its intention to approve the exposure draft, subject to ballot. The Board expects to publish the exposure draft in April 2004.

IAS 12 *Income Taxes*

IAS 12 *Income Taxes* prohibits an entity from recognising a deferred tax liability or asset for temporary differences that arises from the initial recognition of an asset or liability in a transaction that is (i) not a business combination and (ii) at the time of the transaction affects neither accounting profit nor taxable profit ('initial recognition exemption'). Furthermore, IAS 12 explicitly states that an entity does not subsequently recognise changes in this unrecognised deferred tax asset or liability.

US FASB Statement 109 *Accounting for Income Taxes* does not provide specific accounting guidance for asset acquisitions that are not accounted for as business combinations. The US

Emerging Issues Task Force (EITF) addressed this issue in EITF Issue 98-11 *Accounting for Acquired Temporary Differences in Certain Transactions That Are Not Accounted for as Business Combinations*. The EITF concluded that when accounting for the tax effect of single-asset acquisitions in which the amount paid differs from the tax base of an asset, an entity should allocate the consideration paid between the asset and the related deferred tax asset or liability using the simultaneous equations method.

In April 2003, the Board tentatively decided to eliminate the initial recognition exception in order to converge with US GAAP, but expressed concern about converging with the accounting treatment prescribed by EITF 98-11. The primary concern was that application of EITF 98-11 could, in some circumstances, result in a deferred credit in the balance sheet that does not meet the definition of a liability. At that time the FASB staff indicated that the FASB might be willing to move away from the accounting treatment prescribed by EITF 98-11. Accordingly, the Board directed the IASB staff to work with the FASB staff to explore alternative solutions.

The Board discussed three potential approaches to accounting for the tax effects of acquisitions of assets that are not business combinations and when the amount paid is different from the tax base of the asset acquired:

- *View A* – recognise the deferred tax asset or liability as the difference between the consideration paid and the tax base multiplied by the tax rate; the resulting deferred tax benefit or expense is recognised immediately in profit or loss
- *View B* - allocate the consideration paid between the asset and the related deferred tax asset or liability using the simultaneous equations method (EITF 98-11)
- *View C* - allocate the consideration paid between the asset and the related deferred tax asset or liability using the simultaneous equations method; however, any tax benefit in excess of the cost of the related asset is recognised immediately in profit or loss.

The Board tentatively decided to adopt the approach proposed in View C. However, the Board expressed concern about the interaction of the Board's tentative decision and the current definition of 'tax base' in IAS 12. The staff acknowledged that there are differences between the definition of tax base in IFRSs and tax basis in US GAAP. The staff is developing a paper on this issue and will present it to the Board at a later date.

The Board expects to discuss this issue with the FASB at the joint IASB/FASB meeting in April 2004.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

The Board continued its consideration from its February meeting of the definitions of contingent assets and contingent liabilities and their recognition both in and outside a business combination.

Contingent assets

The Board previously tentatively decided that a contingent asset should be defined as "a conditional right that arises from past events from which future economic benefits may flow based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity." At this meeting, the Board considered three examples of items that satisfy the proposed revised definition of a contingent asset:

- a conditional right that arises from an in-process legal claim against a competitor
- a conditional right that arises from an application for an operating licence
- a conditional right that arises from a contract that is in the process of being negotiated between an entity and a customer with whom the entity has had no prior contractual relationship.

The Board affirmed its previous decision that in each of these examples the past event that gives rise to the conditional right (ie the contingent asset) also gives rise to an unconditional right that meets the definition of an asset. The Board noted that, outside a business combination, recognition of this asset would depend on (a) whether the asset meets the identifiability criterion in IAS 38 Intangible Assets and (b) whether it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity. The Board also noted that in determining whether the asset is identifiable and will generate expected future economic benefits, an entity would apply the requirements and guidance in IAS 38 relating to research and development assets. The Board observed that in practice these requirements and guidance impose a high recognition threshold. In a business combination, the Board noted that recognition of the asset by an acquirer would depend on whether the asset meets the identifiability criterion and whether its fair value can be measured reliably.

Contingent liabilities

The Board tentatively decided that a contingent liability should be defined as a "conditional obligation that arises from past events that may require an outflow of resources embodying economic benefits based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity."

The Board considered a number of examples that might satisfy the definition of a contingent liability:

- a conditional obligation under a warranty contract to repair any faults that develop in a product during the warranty period;
- a conditional obligation to pay damages to a litigant in a lawsuit; and
- a conditional obligation arising from a possible change in the law that has retrospective application.

In the first example, the Board observed that the issuing of the warranty is the past event that gives rise to the conditional obligation to repair the product if a fault develops and that this obligation is a contingent liability. It also noted that, in this example, the conditional obligation (ie contingent liability) is accompanied by an unconditional obligation that meets the definition of a provision in IAS 37, because the entity is contractually obliged to honour the conditional obligation if a fault develops. The Board concluded that, both in and outside a business combination, this unconditional obligation should be considered for recognition.

In the second example, the Board concluded that an entity's obligation to pay damages is conditional on a decision of the court and therefore meets the definition of a contingent liability. However, the Board observed that once the entity is involved in litigation, it has lost discretion because it is obliged to perform as the court decides. Therefore, the Board decided that, if the entity had not previously determined that it had caused the litigant damage (and therefore had already determined that it had incurred a liability), the start of legal proceedings should be regarded as a past obligating event that gives rise to a present obligation. The Board noted that in the case of lawsuits, this would mean that the contingent liability (ie conditional obligation) would always be accompanied by an unconditional obligation. As with the first example, the Board concluded that the unconditional obligation should be considered for recognition.

In the third example, the Board concluded that when an entity's past actions would result in an obligation as a result of a change in the law, the entity has a contingent liability until the law is substantively enacted. For example, the Board decided that before the EU end-of-life vehicle directive was substantively enacted, European car manufacturers and importers had a contingent liability for the conditional obligation to take back vehicles they had manufactured that would be in existence after 2006. However, in contrast to the two previous examples, the Board concluded that the contingent liability was not accompanied by an unconditional obligation. The Board directed the staff to consider further the treatment in a business combination of conditional obligations that are not accompanied by unconditional obligations. In particular, the Board questioned whether the business combination might give rise to an unconditional contractual stand ready obligation for an acquirer.

The Board also directed the staff to (a) develop and consider some examples of contingent liabilities with multiple conditions and (b) consider further the recognition and measurement of unconditional obligations that accompany conditional obligations outside of a business combination when the measurement attribute is not fair value.

IFRIC issues

Decommissioning, Restoration and Similar Liabilities

IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* was approved in principle by the IFRIC in February 2004 (see the February 2004 issue of *IFRIC Update*). A final draft was presented to the Board for approval.

The Board decided to approve the issue of IFRIC 1, subject to changes that it referred back to the IFRIC, including:

- the removal of mineral rights and mineral reserves from its scope (reverting to the scope of the exposure draft, D2);
- the addition of an exemption for first-time adopters, who will now be able to use a simplified transition method rather than the full retrospective application method that would otherwise be required; and
- further clarification and disclosure of the treatment of revalued assets.

Employee benefit plans with a minimum guaranteed return on contributions or notional contributions

The IFRIC approved for publication a draft IFRIC Interpretation on employee benefit plans with a minimum guaranteed return on contributions or notional contributions. The draft Interpretation analyses the change in a plan liability that is based on the value of specified assets but is not funded into an expected return and an actuarial gain or loss. The entity's accounting policy for the recognition of actuarial gains and losses applies. The Board had questioned whether it was within the IFRIC's mandate to extend the notions of expected return and deferral of actuarial gains and losses beyond the definitions currently in IAS 19 *Employee Benefits*.

The Board decided that the draft Interpretation was within IFRIC's mandate. The Board did not object to the publication of the draft Interpretation.

Post-employment benefits

The Board considered a pre-ballot draft of an exposure draft of short-term amendments to IAS 19 *Employee Benefits*. The Board decided that:

(a) no change should be made to the requirements in IAS 19 relating to the inclusion of post-employment benefit costs in the cost of other assets.

(b) the statement of changes in equity that excludes transactions with owners should be entitled 'statement of recognised income and expense' as illustrated in the Implementation Guidance accompanying IAS 1 *Presentation of Financial Statements*.

(c) the exposure draft should make it clear that the option to recognise actuarial gains and losses in the period in which they occur outside profit or loss is a third option relating to the recognition of actuarial gains and losses. IAS 19 already allows immediate recognition in profit or loss and deferred recognition in profit or loss.

(d) the requirement to disclose sensitivity information about medical cost trend rates should be expressed in a way that is relevant for entities in a high inflation environment.

(e) the wording of the disclosure requirement relating to the general description of the plan (paragraph 121 of IAS 19) should require the description to be based on all of the terms of the plan that are included in the measurement of the plan.

(f) the exposure draft should be clear that any adjustment arising from the limit on the amount of a surplus that can be recognised as an asset is recognised outside profit or loss only if the entity's accounting policy is to recognise outside profit and loss actuarial gains and losses in the period in which they occur.

Reporting comprehensive income

Background

The IASB, Financial Accounting Standards Board (FASB), and the UK Accounting Standards Board (ASB) have agreed that convergence is an important goal in their projects on reporting comprehensive income. In October 2003, the boards suggested that their staff should form a working group:

- to identify areas in which the boards converge and in which the boards differ on their projects
- to recommend an action plan to reduce areas in which boards opinions differ, and
- to develop a timetable to issue public proposals or discussion documents.

The working group identified the major areas of differences between the boards and developed a proposal towards convergence. At the March 2004 meeting, the IASB staff presented and discussed the working group's proposed project goals and the alternative approaches to meeting the project goals.

Revenue recognition

The Board discussed a paper on the definition of revenues that focused on the *amount* of revenues, rather than when revenues are recognised. The Board did not make decisions about the definition of revenues. It provided comments to the staff on the approach to explore at the Board's joint meeting with the FASB in April 2004. The Board suggested exploring whether:

(a) consistent with the IASB *Framework*, income and expenses should be defined as all changes in equity other than those resulting from investments by owners. (The Board decided in December 2003 that transactions and other events giving rise to either increases or decreases in equity could result in the display of revenues.).

(b) inflows of economic benefits should be presented on a gross basis in the income statement when that treatment is relevant to users of financial statements. These gross inflows could include, but not necessarily be limited to, revenues. When revenues are recognised, the related expenses would also be recognised on a gross basis.

(c) the criterion for grossing up inflows and outflows of economic benefits resulting from transactions should be that the transactions are with customers. The Board noted that this customer criterion might not be sufficiently robust. For example, not all counter-parties would necessarily be customers. Therefore, the Board also suggested exploring whether the criterion for grossing up inflows and outflows of economic benefits resulting from transactions should be that the transactions result from particular types of activities (for example, those involving ongoing major or central operations). Sales of the entity's "infrastructure" might not meet the criteria for grossing up.

(d) customers should be defined broadly enough for inflows of economic benefits resulting from the use of the entity's assets (such as rent, interest, royalties and dividends) to be classified as revenues, at least if they arise from the activities referred to in (c).

(e) increases in the amounts of assets resulting from some types of activities preceding the provision to customers of goods, services or the use of the entity's assets could be revenues.

The Board discussed possible amendments and clarifications of draft recognition and measurement principles for revenue recognition it considered at its February 2004 meeting. The Board tentatively decided:

(a) to reconfirm that a contract arises when legally enforceable promises are made. It is unnecessary to specify in the replacement standard for IAS 18 *Revenue* a rebuttable presumption that a customer contract does not exist unless its existence is documented in accordance with the entity's customary business practice for similar contracts.

(b) to reconfirm that a contract should be defined as a set of promises that a court will enforce.

(c) that guidance on the definition of a contract should be provided in the replacement standard for IAS 18. For example, while local law and practices need to be considered, common requirements of a contract (as defined) include (i) mutual assent, (ii) bargained-for consideration, (iii) capacity and (iv) legality of object. In addition, guidance should be included to emphasise that legal enforceability is an essential characteristic of a contract.

(d) that the replacement standard for IAS 18 should include guidance on enforcement worthiness in respect of contracts. For example:

> A contract conveys to the seller rights for which the seller can seek enforcement by the courts. However, the costs of enforcing some enforceable rights may exceed the benefits of doing so. In case of breach, a seller might not seek to enforce a contract if the combination of direct costs (such as legal fees) and perceived indirect costs (such as customer "ill will" costs) exceeds the benefits expected to be obtained as a result of the enforcement action. The assessment of the probability that contractual rights will contribute to future net cash inflows and contractual obligations will result in future net cash outflows should affect measurement, but not recognition of related assets and liabilities.

(e) that the following proposed Recognition Principle should be withdrawn from the revenue recognition model, at least until further development of the revenue recognition project:

> Contractual revenues should be recognised upon contract completion to reflect any final increases in the fair values of contractual assets or final decreases in the fair values of contractual liabilities.

The Board also discussed the nature of the obligations that should be included in the scope of the replacement standard for IAS 18 and tentatively decided that:

(a) only obligations that are legally enforceable should be within the scope of the standard;

(b) these obligations would include legally enforceable obligations currently described in the accounting literature as not being legal obligations, such as some 'constructive obligations' and 'equitable obligations;; and

(c) in the absence of evidence to the contrary, all promises to customers should be presumed to be legally enforceable.

Accounting and financial reporting by small and medium-sized entities

The Board discussed the first draft of a Discussion Paper setting out the Board's preliminary and tentative views on the approach to the project developing accounting standards for small and medium-sized entities (SMEs) and the reasons for those views, with comments invited. A summary of the Board's preliminary views can be found in the February 2004 issue of *IASB Update*, as well as on the SME project page on the IASB's Website.

The Discussion Paper will include specific questions for respondents on the Board's preliminary views. It will also set out alternatives that were considered and the arguments for and against each.

The Board asked the staff to make clarifications in the draft Discussion Paper, including the following:

- The Board's standards for SMEs would be suitable for any entity that does not have public accountability (IFRSs would apply to publicly accountable entities). Appropriate regulatory authorities within each national jurisdiction can decide which non-publicly accountable entities in their jurisdiction would be required or permitted to follow the IASB standards for SMEs.
- When an IASB standard for SMEs provides an exemption or simplification from a provision in the related IFRS, an entity following IASB standards for SMEs would not be prohibited from applying the provision in the related IFRS. The entity's financial statements would be described as conforming to IASB standards for SMEs if the entity uses one or more of the exemptions or simplifications for SMEs.

The staff plans to redraft the Discussion Paper based on the Board's comments with the objective of seeking the Board's approval to issue it at the April 2004 meeting.

The Board decided that the Discussion Paper would have a 90-day comment period.

Meeting dates: April 2004

The Board will next meet in public session in London on 21 April. On 22 and 23 April, the Board meets the FASB and on 26 and 27 April the Board meets the partner national standard-setters. Venues vary; please check the IASB Website for details.

