IASB
BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS
UPDATE
May 2004

The International Accounting Standards Board met in London on 18 and 19 May 2004, when it discussed:

- Business combinations (phase II)
- Consolidation
- Financial instruments
- Financial risk disclosures
- IFRIC issues
- Revenue recognition
- Small and medium-sized entities

Business combinations

The Board considered:

- issues identified by the staff while drafting the Exposure Draft of Amendments to IFRS 3 *Business Combinations*
- issues that the FASB had considered as part of the project that the Board had not yet considered.

Definition of a business

The Board considered whether to revisit in this project the definition of a 'business' included in IFRS 3, with a view to converging with the FASB. Specifically, the Board considered whether:

- to revise the definition of a 'business' for consistency with the definition proposed by the FASB;
- to provide additional application guidance consistent with that being proposed by the FASB;
- to provide illustrative examples on the application of the definition and guidance consistent with those being proposed by the FASB.

The accounting for the acquisition of a group of assets varies depending on whether that group is a business. When an entity acquires a group of assets or net assets that does not constitute a business, IFRS 3 clarifies that the entity allocates the cost of that group among the individual identifiable assets and liabilities in the group on the basis of their relative fair values at the date of acquisition. In contrast, the Board's decisions in this project would mean that, when an entity acquires a group of assets or net assets that constitute a business, it would first measure the transaction at the fair value of the net assets over which the entity has obtained control. Then it would recognise that amount by separately recognising the assets acquired and liabilities assumed at their fair values at the acquisition date. Any excess of the fair value, at the acquisition date, of the net assets over which the entity has obtained control over the net fair value of the *identifiable* assets and liabilities so recognised would be recognised separately as goodwill. Consequently, there is a need to clarify when a group of assets or net assets constitutes a business.

The Board concluded that, conceptually, acquisitions of all groups of assets should be accounted for in the same way. Therefore, it decided to ask the FASB to reconsider whether the scope of this joint project should be expanded to consider the accounting for groups of assets or net assets that do not constitute a business.

The Board decided that if the scope of the project was not expanded to address this matter at this time, it should revise the definition of a business in IFRS 3 as follows:

- the word 'generally' should be removed from the second sentence of the definition of a business in IFRS 3.

  The Board observed that the word *generally* was intended to leave open the possibility that an entity could be a business, even though it might not yet have outputs used to generate revenues. The Board concluded that relying on the word *generally* might lead to inconsistent judgments and application in practice. Therefore, it decided to clarify in the application guidance that an entity (a) might not yet have outputs used to generate revenues, but (b) might nevertheless be a business. In assessing whether an entity without outputs is a business, the following factors should be considered:

  - whether the entity has begun planned principal activities;
  - whether the entity has employees, intellectual property, and other inputs and processes;
  - whether the entity is pursuing a plan to produce outputs;
  - whether the entity has the ability to obtain access to the customers that will purchase the outputs.

  However the Board decided not to include additional application guidance the FASB intends to provide.
- the presumption that if goodwill is present in a transferred set of activities and assets, the transferred set should be presumed to be a business should be removed from the definition, and instead included in the application guidance. The Board also decided to ask the FASB to reconsider including application guidance that the presence of elements of 'core goodwill' (as described in the Basis for Conclusions on SFAS 141 *Business Combinations*) in a transferred set of activities and assets are an indication that the transferred set is a business.

The Board also decided that if the scope of the project were not expanded to address the accounting for groups of assets that are not a business, paragraph 4 of IFRS 3 should be amended. The amendment would clarify that when an entity acquires such a group, it should (a) identify and separately recognise all identifiable

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Business combinations (phase II) *(continued)*

assets acquired and liabilities assumed, including those assets that meet the definition of, and recognition criteria for, intangible assets in IAS 38 *Intangible Assets* and (b) allocate the cost of the group between the individual identifiable assets and liabilities on the basis of their relative fair values at the date of acquisition.

Whether the 'purchase method' should be renamed the 'acquisition method' and the title of IFRS 3 changed

The Board considered whether to replace the term 'purchase method' throughout IFRSs with the term 'acquisition method' in the light of the FASB's decision to use the term 'acquisition method'. The Board agreed with the FASB that 'acquisition method' is broader and communicates better that this method also applies to business combinations in which control is obtained through means other than a *purchase* of net assets or equity interests. In addition, because the boards are proposing to change the cost-based procedures previously associated with the purchase method to procedures based on fair value, 'acquisition method' is more suitable.

The Board then considered whether to change the title of IFRS 3 in the light of the FASB's considerations about using one of several proposed titles for the revised SFAS 141.

The Board decided not to change the title of IFRS 3. Some transactions or events that meet the definition of a business combination, but are currently excluded from the scope of IFRS 3 (such as the formation of joint ventures), will be considered by the Board as part of future phases of its Business Combinations project. The Board was concerned that such transactions might be permanently excluded from the scope of IFRS 3 if the Board adopted one of the titles the FASB is considering. In addition, the Board decided that it should not, in the first phase of its Business Combinations project, rule out the possibility of a combination (other than a combination involving the formation of a joint venture) in which one of the combining entities does not obtain control of the other combining entity or entities. Such combinations are sometimes referred to as 'true mergers' or 'mergers of equals'.

The Board also noted that it was committed to exploring in a future phase of its Business Combinations project whether the 'fresh start' method might be applied to some combinations.

Whether IAS 12 should be amended to address explicitly deferred tax assets arising from goodwill

IAS 12 *Income Taxes* does not address explicitly the recognition of deferred tax assets arising from the initial recognition of goodwill (ie whether a deferred tax asset arising from an excess of the tax base of goodwill over the carrying amount of goodwill should be recognised as part of the accounting for a business combinations). Consequently, the general requirements of IAS 12 paragraph 24 would apply requiring the deferred tax asset to be recognised to the extent it is probable that taxable profit will be available against which the deductible temporary difference could be utilised.

The Board considered whether IAS 12 should contain an *explicit* requirement to recognise such tax assets as part of the business combination accounting. The Board considered this issue because the FASB decided as part of the joint project explicitly to require the tax benefit arising from tax deductible goodwill in excess of goodwill for financial reporting purposes to be accounted for at the date of the acquisition as a deferred tax asset as part of the business combination accounting.

The Board also decided that IAS 12 should be amended explicitly to require recognition of a deferred tax asset arising from excess tax goodwill as part of the business combination accounting.

Recognition and measurement of operating leases acquired in a business combination

The Board considered how assets and liabilities arising from operating leases acquired in a business combination should be presented as part of the initial accounting for a business combination.

The Board decided that leases acquired in a business combination should be classified as operating leases or finance leases in accordance with their classification by the acquiree at inception. After the business combination, they should be accounted for in accordance with IAS 17 *Leases*. Assets and liabilities arising because an acquiree's operating leases are favourable or unfavourable would be recognised at their fair values at the acquisition date. Such assets and liabilities should be presented as a single net amount for each lease.

Consolidation

The Board discussed the nature of fiduciaries and how the concept of control should be applied to them. As an example, the Board also discussed the notions of *power* and control in the funds management industry. The purpose of the discussion was to give staff direction on how to advance the Consolidation project. No decisions were made.

The Board decided that a fiduciary acting solely in that capacity should not satisfy the control definition[1] even if they can determine another entity's strategic operating and financing policy. However, the Board cautioned that it would be difficult to differentiate fiduciaries from other entities with power and that care would need to be taken to ensure that the notion of fiduciary is applied appropriately. The Board requested the staff to consider how fiduciaries differ from other entities and whether this difference could be described so as to make it operational.

The Board also discussed how power and control should be assessed when a fund manager has two roles in relation to the same investee – a fund manager with power over a fund with a holding in an investee, and a direct investor (principal). Two approaches were considered. In the first approach, each of the fund manager's interests would be analysed separately to determine whether the fund manager has power and control over the investee. In the second approach, the fund manager's interests in the investee would be analysed together.

[1] At the September 2003 meeting the Board discussed the definition of control and tentatively decided that one entity must have the following three abilities for it to control another:

(a) the ability to direct financing and operating policy and strategy (the 'power criterion');

(b) the ability to access benefits (the 'benefit criterion'); and

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

Financial instruments

IAS 39 *Financial Instruments: Recognition and Measurement* – Cash flow hedge accounting of forecast intragroup transactions

The Board discussed concerns raised by constituents about the inability to designate in consolidated financial statements a forecast intragroup transaction, denominated in a foreign currency, as the hedged item in a foreign currency cash flow hedge. The forecast intragroup transaction is highly probable and will result in the recognition of an intragroup monetary item on which exchange differences are not fully eliminated on consolidation.

The Board noted that the issue had widespread and practical relevance and that, in this respect, diverged from US GAAP. Accordingly, the Board decided to address the issue.

The Board decided:

- to clarify that, in group financial statements, an entity can designate as the hedged item a highly probable forecast *external* transaction that is denominated in the functional currency of the group entity that enters into the transaction, provided that the transaction gives rise to an exposure that has an effect on consolidated profit or loss (ie it is denominated in a currency other than the group's presentation currency).
- to amend IAS 39 to include this clarification in the application guidance.
- that the effective date of the proposed amendment would be accounting periods beginning on or after 1 January 2006 with early application permitted.
- to include this proposed amendment in an Exposure Draft to be published with the Exposure Draft of Amendments to IAS 39 and IFRS 4 *Insurance Contracts* on Financial Guarantees and Credit Insurance and Amendments to IAS 39 on Transition and Initial Recognition of Financial Assets and Financial Liabilities.

IAS 39: Update on Developments

The Board received an update on continuing discussions between representatives of the Board and the European Banking Federation (FBE).

At the group's last meeting, the IASB and FBE representatives discussed:

- technical issues related to the application, by banks, of the cash flow hedge accounting requirements of IAS 39 and the implementation guidance contained in Questions and Answers F.6.1-F.6.3.
- the FBE's proposal that a new type of hedge accounting should be developed for hedges of interest rate margin. The Board agreed to continue discussions with the representatives from the FBE and directed the staff to prepare a summary of the issues that arise from the proposal. The staff will identify those aspects of the proposal that require further development for discussion at a future meeting of Board and FBE representatives following the June 2004 Board meeting. The Board acknowledged that the goal was to develop, as soon as possible, the proposal to the point that it would be appropriate for presentation to the Board. The Board indicated that it would then consider whether it should issue an exposure draft on the proposals.
- the presentation of cash flow hedges in the balance sheet and statement of changes in equity. The Board agreed to continue discussions of possible presentations with the FBE. The objective of the discussions is to assist the banking industry to find a presentation that communicates information about cash flow hedges without violating principles in IFRSs or potentially misleading readers of the financial statements. The Board noted that any presentation must comply with the requirements of IAS 39 and IAS 1 *Presentation of Financial Statements*. In particular, gains and losses from hedges of future cash flows must be included in equity. However, these Standards do not mandate a single presentation format. Therefore, a variety of presentations could be used to highlight, within equity, the effects of cash flow hedges and to distinguish this component of equity from other components of equity. The Board unanimously decided not to consider amending the IASB *Framework* to include a new balance sheet category, other than assets, liabilities or equity, for the presentation of cash flow hedges.

Financial risk disclosures and other amendments to financial instruments disclosures

The Board resumed its discussion of financial risk disclosures and other amendments to financial instruments disclosures. This project was formerly referred to as "the financial activities project" and began as a project to revise IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*. The project has been undertaken with the assistance of the Financial Activities Advisory Group.

The Board decided:

- to confirm its previous decision to publish an Exposure Draft
  - (a) of an IFRS that would replace the risk disclosures in IAS 32 *Financial Instruments: Presentation and Disclosure*.
  - (b) of an amendment to IAS 32 that would require disclosure of:
    - the carrying amounts of financial instruments by IAS 39 measurement classification
    - gains (losses) recognised in profit or loss by IAS 39 measurement classification
    - the allowance account used to reduce the carrying amount of impaired financial assets
    - fee income and expense, as an additional category of "significant items of income and expense" in IAS 32 paragraph 94(h)
  - (c) of an amendment to IAS 1 that would require disclosures about capital.
- to locate all disclosures relating to financial instruments in the proposed IFRS, including (a) and (b) above, and those currently in IAS 32. As a result, IAS 32 would contain only requirements for presentation (ie the debt/equity distinction and offsetting).
- that the staff should evaluate each disclosure requirement in the proposed Exposure Draft to ensure that it is necessary.
- that guidance would be provided to suggest ways to apply the risk disclosure requirements proposed in the Exposure Draft. This guidance would accompany, but not be part of, the IFRS.
- to include in the Exposure Draft an example of a capital disclosure for a non-financial institution.
- to propose that the new IFRS should be mandatory for accounting periods beginning on or after 1 January 2007, with early adoption encouraged.

- to propose an exemption from the requirement to produce, in the first year of adoption, comparative information that complies with the proposed IFRS for entities that (a) adopt IFRSs for the first-time before 1 January 2006, and (b) early adopt the proposed IFRS before that date.
- to propose amendments to the risk disclosures in IFRS 4 *Insurance Contracts* to make them consistent with the requirements proposed in the Exposure Draft. This would affect paragraphs 39(a), 39(b) and 39(d) of IFRS 4, and the associated implementation guidance in paragraphs IG41-IG50 and IG62-IG65.
- to note in the Exposure Draft that the FASB's forthcoming Exposure Draft on fair value measurements will propose some disclosures that are different from some of the disclosures currently required by IAS 32, which would be relocated into the new IFRS, and to ask a question about whether the IASB should narrow the differences.

The Board decided to proceed to a pre-ballot draft of the Exposure Draft. No Board member indicated an intention to express an alternative view.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Proposed Amendments to IAS 37

The Board reconsidered the amendments that it had previously decided to make to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The amendments derive from two of the Board's projects:

(a) the Short-term Convergence project, in which the Board has sought convergence of the recognition requirements relating to restructuring costs in IAS 37 with those of SFAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*; and

(b) the second phase of the Business Combinations project, in which the Board has amended the definitions of contingent assets and liabilities.

The amendments to the requirements relating to restructuring costs in IAS 37 require consequential changes to the requirements relating to termination benefits in IAS 19 *Employee Benefits*. (These decisions were set out in the observer note prepared for the meeting, available at www.iasb.org.)

The Board confirmed its previous decisions and directed the staff to prepare an Exposure Draft. The Board also directed the staff to incorporate some additional material into the Exposure Draft. In particular:

- IAS 38 *Intangible Assets* should be amended to clarify that some unconditional rights accompanying contingent assets would be within its scope.
- the definition of a constructive obligation as currently drafted is incomplete because it could permit the recognition of amounts as liabilities when the entity has no present obligation. The Board asked the staff to ensure that the Exposure Draft clarified that a constructive obligation requires an obligating event.
- the measurement requirements in IAS 37 should clarify that the amount that an entity would rationally pay to settle the obligation at the balance should reflect the risks and uncertainties surrounding the obligation.
- the title of IAS 37 should be changed to *Provisions and Contingent Liabilities*, given that the requirements relating to unconditional rights accompanying a contingent asset are in Standards other than IAS 37.

The Board decided that the Exposure Draft should be issued at the same time as the exposure draft of amendments to IFRS 3 *Business Combinations* (ie the second phase of the Business Combination project).

No Board member indicated an intention to present an Alternative View in the Exposure Draft.

IFRIC issues

The Board received an update recent activities relating to the IFRIC. In particular, the Board noted the following:

(a) the IFRIC concluded its deliberations on the content of a Draft Interpretation dealing with members' shares in co-operative entities. Clearance of the Draft Interpretation would be sought from the Board as soon as a draft was available.

(b) the Board had approved issuance of the consequential amendments to IFRS 1 *First Time Adoption of International Financial Reporting Standards* arising from IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities.* IFRIC 1 will be released as soon as possible.

(c) after its June 2004 meeting, the IFRIC expects to issue a Draft Interpretation proposing to remove the scope exclusion in SIC-12 *Consolidation – Special Purpose Entities* related to equity compensation plans. The Draft Interpretation may also deal with the scope issues relating to long-term employee benefit plans;

(d) the IFRIC discussed the role of fiduciaries in relation to control as defined in IAS 27 *Consolidated and Separate Financial Statements*. The IFRIC deferred its discussion because of the Board's planned discussions on this issue (see *Consolidation*, above).

(e) the IFRIC will send to the Board for its July meeting a marked-up version of IAS 41 *Agriculture* and a position paper on fair value issues that have arisen in applying IAS 41;

(f) the IFRIC continued its discussions on concessions and the related matter of combining and segmenting construction and service contracts. Several Draft Interpretations are likely later in the third quarter of 2004.

(g) the IFRIC considered comment letters on Draft Interpretations D3 *Determining whether an Arrangement Contains a Lease* and D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds*.

(h) at its June 2004 meeting, the IFRIC will consider sweep issues arising from finalising Draft Interpretation D7 *Employee Benefit Plans with a Promised Return on Contributions or Notional Contributions*. The Draft Interpretation would then be forwarded to the Board.

Following from discussions under (f), the Board queried the IFRIC's intention to address the generic issue of sale and leasebacks with repurchase agreements instead of the broader issue of when a sale should be recognised in a sale and leaseback arrangement. The staff explained that the narrower topic arose frequently in the context of concessions and that the IFRIC considered that it was constrained on the broader issue by the IFRSs. However, the IFRIC Agenda Committee will consider the wider issue as well.

Revenue recognition

The Board discussed the following question: If an entity's performance obligations to its customers are measured at fair value, how should the fair value of those obligations be determined?

The Board decided that to determine the fair value of an entity's performance obligations to a customer, it is necessary to analyse the contract with the customer to identify all obligations to the customer. The main alternatives for determining fair value considered by the Board were:

(a) using the price that would have to be paid to a third party to assume, at the measurement date, legal responsibility for performing all of the entity's remaining obligations. This amount is an "all-in price" for the entity's performance obligations, including any performance guarantees.

(b) basing fair value on the amount of consideration paid or to be paid to the entity by the customer.

The Board decided that, in concept, fair value should be measured using alternative (a). However, it raised issues regarding the application of that concept.

The Board asked the staff to consider potential constraints on applying that concept, such as difficulties in measuring fair value with sufficient reliability and cost/benefit considerations, and possible practical alternatives. That consideration should include identifying when a measure of fair value would lack reliability.

Financial reporting standards for small and medium-sized entities

At its April 2004 meeting, the Board reached the preliminary view that if an SME that is otherwise using IASB standards for SMEs elects to use a treatment in an IFRS that differs from the treatment in the related IASB standard for SMEs, it must use that IFRS in its entirety, not just selected parts of it. That preliminary view is to be included in the forthcoming Discussion Paper on Accounting Standards for SMEs.

In May 2004, the Board considered whether an entity's decision to use a treatment in an IFRS should trigger a requirement to use the recognition and measurement standards in the IFRS that are not interrelated with the one that the entity wishes to use.

The example discussed was an entity wishing to amortise premium/ discount using the effective interest method if the principle in the IASB Standard for SMEs were to be straight line. Under the Board's preliminary view, using the effective interest method would require the entity to use all of IAS 39. Therefore, even if the SME version of IAS 39 were to include, for example, some simplifications relating to hedge accounting, those simplifications would not be available to the SME using the effective interest method.

After discussion, the Board reaffirmed its preliminary view that reversion to an IFRS should be to the IFRS in its entirety. At the same time, the Board agreed to add a question to the Discussion Paper's Invitation to Comment regarding the on this issue.

The Board expects to publish the Discussion Paper in the second quarter of 2004.

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—25 June, Oslo, Norway†

20—22 July

22—24; 27§, 28‡ September

18—20 October, Norwalk, Connecticut, USA

15—19 November†

15—17 December

† Includes a meeting with the Standards Advisory Council

‡ Includes meetings with partner standard-setters

§ Includes meetings with other national standard-setters