BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

October 2005

The International Accounting Standards Board met in London on 18-20 October, when it discussed:

- Update on IFRIC activities
- Service Concessions
- Insurance Contracts (Phase II)
- Proposed Technical Correction: IFRS 1 and IAS 12
- Business Combinations II
- Short-term convergence: borrowing costs
- Conceptual Framework
- Revenue recognition
- Financial instruments
- Consolidation
- Performance reporting

The IASB also met with the Financial Accounting Standards Board in a joint meeting on 24 and 25 October where they discussed

- Comprehensive Business Reporting Model
- Reporting financial performance
- Revenue recognition
- Short-term convergence: taxes
- Financial instruments
- Conceptual Framework

Update on IFRIC Activities

The staff reported on the latest two meetings of the IFRIC (see IFRIC Update for August and September).

The discussion focused on the report in September's IFRIC Update setting out the IFRIC's interim guidance on the interaction between the requirements of IAS 19 regarding the asset ceiling and the effects of a statutory minimum funding requirement (MFR). The Board noted that problems arose only when the MFR obliges an entity to fund to a level higher than the IAS 19 liability and local law or the terms of the plan restrict an employer from recovering excess plan assets. The Board accepted that the interim guidance was built on the requirements related to the asset ceiling in IAS 19. The Board had considered issuing such guidance when it finalised the asset ceiling requirements, but decided that it was unnecessary. The staff explained that there are requests for guidance.

Service Concessions

The Board held an education session on the IFRIC's work on service concessions. No decisions were made.

Insurance Contracts (phase II)

The Board held an education session on continuation, cancellation and renewal options in insurance contracts, led by Phil Arthur and Jim Milholland of Ernst & Young and Hitesh Patel and Terry Harding of KPMG. Their presentation is available at www.iasb.org/meetings/oct2005.asp.

No decisions were made.

The Board expects to hold education sessions on reinsurance and insurance-linked securities (November) and participation features (December).

Proposed Technical Correction: IFRS 1 and IAS 12

The Board discussed whether it should propose a technical correction to eliminate an inconsistency in how IFRS 1 *First-time Adoption of International Financial Reporting Standards* requires a first-time adopter to treat deferred tax arising from an intangible asset acquired in a past business combination.

A first-time adopter is required by IFRS 1 to adjust opening retained earnings if, on transition to IFRSs, it recognises for the first time a deferred tax liability relating to an acquired intangible asset recognised in accordance with its previous GAAP. In contrast, if the entity had subsumed the intangible asset in recognised goodwill in accordance with its previous GAAP, it would be required to decrease the carrying amount of goodwill accordingly and, if applicable, adjust deferred tax and minority interests.

The Board decided not to propose a technical correction.

Business Combinations II

The Board discussed the planning for the forthcoming round-tables on business combinations and the redeliberation processes. The Board observed that these will be the first joint round-tables the Boards have held. The Board expressed concern that there are differences in the ways the round-tables hosted by the IASB and the FASB are conducted. The staff assured the Board that the differences are primarily influenced by logistical constraints. The staff will ensure that a review of the round-tables is conducted after they have been completed.

The Board discussed the preliminary planning schedule. The staff outlined the risks that could affect the timing of the project, including the other projects that have implications for Business Combinations II. The Board decided that the timetable was optimistic and that it was unlikely that a revised IFRS 3 could be issued before the end of 2006. The Board also noted that some jurisdictions require additional time for processes to give IFRSs legal effect. The Board decided to develop a general policy on the effective date for new standards, relative to their publication date.

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ISSN 1474-2675

Short-term convergence: borrowing costs

The Board considered a short-term convergence project on the capitalisation or immediate recognition as an expense of borrowing costs incurred in the construction or development of qualifying assets. The Board decided to amend IAS 23 to remove the existing option to recognise borrowing costs immediately as an expense.

The Board also asked the staff to prepare a paper setting out the changes that would be required to achieve convergence on all aspects of IAS 23 *Borrowing Costs* and SFAS 34 *Capitalization of Interest Cost*. The Board will then consider whether it should make changes to definitions of qualifying assets and interest costs to be capitalised.

Conceptual Framework

The Board continued its deliberations on the joint IASB/FASB conceptual framework project. In preparation for the meeting with the FASB, the Board discussed issues relating to:

- suggestions for improving the process for assessing the qualitative characteristics of financial information;
- whether the objectives of financial reporting and qualitative characteristics of financial information would differ for particular types of business entities (for example, small versus large, private versus public);
- a staff milestone draft for the Objectives of Financial Reporting section of a due process document, including considerations about seeking constituents' comments; and
- project status, plans, and priorities.

No decisions were made.

Revenue recognition

The Board continued its deliberations on the joint IASB/FASB revenue recognition project. In preparation for the meeting with the FASB, the Board discussed issues relating to developing a new conceptual model for revenue recognition and a general standard derived from that model.

The Board discussed examples to illustrate the allocation approach decided upon at the September meeting, possible refinements to that approach and aspects of the definition of revenue. No decisions were made.

Financial instruments

The Board discussed two papers in preparation for the meeting with the FASB. The first paper suggested possible long-term objectives for improving financial reporting for financial instruments and outlined the nature and status of the current and possible future work programme. The second paper discussed possible methods of disaggregating changes in the fair value of financial instruments. No decisions were made.

Consolidation

The Board has recently become aware of differences in how IAS 27 might be applied in the circumstances in which an entity owns less than half the voting power in an entity. The Board discussed the definition of control in IAS 27 and decided to make a statement outlining its views on de facto control. That statement is reproduced in the highlighted box.

Control under IAS 27 *Consolidated and Separate Financial Statements*

IAS 27 contemplates that there are circumstances in which one entity can control another entity without owning more than half the voting power.

During its deliberations on its control project, the Board confirmed its view that an entity holding a minority interest can control another entity in the absence of any formal arrangements that would give it a majority of the voting rights. For example, control is achievable if the balance of holdings is dispersed and the other shareholders have not organised their interests in such a way that they exercise more votes than the minority holder. This is sometimes referred to as 'de facto control'.

During those deliberations, the Board has made it clear that, in its view, the control concept in IAS 27 includes de facto control. The Board also acknowledged that professional skill and judgement is required in applying the control concept including determining if de facto control exists. The Board has recently become aware that some who apply IFRSs hold the view that, in the circumstances described, IAS 27 requires an entity to have legal control over a majority of the voting rights to consolidate another entity.

The Board accepts that it would have been helpful if IAS 27 had included guidance to assist preparers in exercising the judgement to apply the control concept. Without that guidance there is a greater risk that two entities faced with the same set of circumstances might reach different conclusions on whether they control another entity. The Board is aware that differences in the application of IAS 27 might also be influenced by the practices followed in jurisdictions before adopting IFRSs.

The Board has made progress on its project on control and it could issue an exposure draft to propose amending IAS 27 by adding guidance on de facto control. However, the Board prefers to address comprehensively issues related to control in any possible proposal to amend or replace IAS 27. The Board acknowledges that this approach means that differences in how IAS 27 is applied might persist until its project on control is completed.

Autopilots – control versus risks and rewards

The Board discussed the nature of an investment in an entity when setting the operating and financing policies of the entity has been put on 'autopilot'. The staff highlighted some of the tensions between the control model in IAS 27 and the risk and reward model implicit in SIC-12.

Power

The staff outlined two ways to think about an autopilot arrangement in the context of power. The first is that setting an entity on autopilot is evidence that power has been exercised. The second is that the ability of a party to set an entity on autopilot is evidence that power is immaterial, or not relevant, to assessing whether that entity is a subsidiary of another entity.

The Board asked the staff to pursue the second line of thinking because it believes that it is more likely to yield a workable definition of control than following the first.

Benefits

The staff observed that there are inherent conflicts in the way the control model and the risks and rewards model operate. The Board has decided that 'control' can arise in circumstances in which an investor holds less than half the voting rights in an entity. This effectively places more weight on the power criterion than the benefits criterion. This means that an entity might have power over another entity but be entitled to less than half of the benefits. Yet, when more weight is placed on benefits, the tendency has been to view this in terms of a majority of the benefits.

Next steps

The staff will develop an integrated summary of the determinants of consolidation. That is, the control and risk and reward models will be reconciled as far as possible. The staff also noted that no one attribute or feature is likely to be an appropriate determinant of control in all circumstances.

Accounting for the attribution of profits or losses in the context of potential voting rights

The staff introduced some illustrative examples of the accounting for the attribution of profits or losses in the context of potential voting rights.

The Board asked the staff to develop additional examples and a summary of each of the principles the examples illustrate. The Board asked that the examples be presented at a future education session.

Performance reporting

The Board discussed sweep issues identified in drafting the Proposed Amendments to IAS 1 *Presentation of Financial Statements*.

The Board decided:

- to use 'recognised income and expense' rather than 'comprehensive income' to describe non-owner changes in equity.
- to use the following titles for the four primary financial statements:
  - statement of financial position (formerly, balance sheet)
  - statement of changes in equity
  - statement of recognised income and expense
  - statement of cash flows (formerly, cash flow statement).
- to retain the term 'profit or loss' as the description of the subtotal that is required on the face of the statement of recognised income and expense.
- to permit an entity to use titles for its financial statements other than those used in the Standard (eg an entity is not required to use the title 'statement of recognised income and expense').
- not to require reserves, other than share capital and retained earnings, to be accumulated on the face of the statement of financial position or the statement of changes in equity. The Exposure Draft will continue to require each reserve balance (eg cash flow hedge reserve; revaluation surplus) to be disclosed either on the face of the statement of changes in equity or in the notes.
- to require the disclosure of tax effects associated with each component of other recognised income and expense for the period, ie each component initially recognised outside profit or loss (eg tax effects associated with valuation gains/losses on available-for-sale financial assets).
- that the effective date of the amendments to IAS 1 would be accounting periods beginning on or after 1 January 2007 with earlier application encouraged.
- that no transitional guidance be required.
- that the Exposure Draft of Proposed Amendments to IAS 1 would have a comment period of 120 days.

The Board discussed its tentative decision to require a single statement of earnings and comprehensive income (now titled, statement of recognised income and expense). The Board expressed its preference for a single statement. However, a majority of the Board would be willing to allow an entity the choice of presenting income and expenses in either one statement or two, provided the FASB also agreed to that proposal. No decisions were made.

Joint meeting – IASB and FASB

Comprehensive Business Reporting Model

The CFA made a presentation to the boards on its Comprehensive Business Reporting Model. No decisions were made.

Reporting financial performance

The boards discussed whether to include a financing category in the statement of recognised income and expense (ie the statement of earnings and comprehensive income) as part of Segment B of the Performance Reporting project. The staff asked the boards for direction on how it should structure work on the definition of a financing category. In this part of the project the staff will focus on non-financial institutions.

The boards decided that:

- transactions and events of a financing type should be aggregated and displayed as a category on the face of the statement of recognised income and expense.
- a definition for a financing category should be developed before any other category, such as operating.
- the definition of financing should be applied consistently by all entities, excluding financial institutions.

The boards discussed several approaches the staff might use to define a financing category. No decisions were made.

Revenue recognition

The boards discussed the following:

Refinements to decisions reached in September

The boards refined some decisions reached in prior board meetings. They:

- clarified that the definition of performance obligations should include obligations to provide not only goods and services but also other rights, such as rights of use;
- noted that the costs incurred to extinguish a performance obligation would be recognised as a component of comprehensive income and not as a reduction of the recognised performance obligation;
- clarified the criteria for disaggregating contracts involving several performance obligations into separate components (‘units of account’); and
- refined the proposed description of the way in which the customer consideration would be allocated among those units of account.

One of the proposed criteria for disaggregating contracts into separate units of account is that the goods, services or other rights underlying a performance obligation are sold separately or as an optional extra by any vendor or could be resold separately by the customer. The boards decided to specify the market in which such sales by the customer would take place, and asked the staff to consider how to define that market.

At their separate meetings in September, the boards made decisions regarding the initial measurement of performance obligations in revenue contracts involving more than one unit of account. The boards decided that the total customer consideration should be allocated to each unit of account based on the price at which the underlying good, service or other right would be sold on a stand-alone basis. That price would be estimated by reference to the most reliable available evidence. At the October joint meeting, the boards affirmed that decision and asked the staff to review the guidance on estimating stand-alone prices in the absence of market evidence for consistency with the overall measurement objective.

At their September meetings, the boards considered whether to make exceptions to the general proposal that performance obligations should be initially measured at the allocated customer consideration amount. Both boards decided to make an exception for obligations—such as financial liabilities—that are required to be measured at fair value by other accounting standards. However, they reached different conclusions on whether to make a similar exception for all unconditional stand-ready obligations. The FASB decided those obligations should be measured at the allocated customer consideration amount (unless required to be measured at fair value by another accounting standard) while the IASB decided they should be initially measured at fair value. At their October meeting, the boards decided to present both views in the Discussion Paper. The IASB further clarified that an unconditional stand-ready obligation would be measured at fair value even if that obligation is the only obligation in the arrangement. That means that for some arrangements, a reporting entity might recognise some revenue at the inception of the contract.

In September the boards decided to explore an alternative measurement principle that would permit or require a fair value measurement for any performance obligations that trade in active markets. At the October meeting the boards agreed to defer consideration of this alternative until the allocated customer consideration approach is more fully developed.

Illustrative examples

The boards considered examples that illustrated the customer consideration allocation approach. They noted that the examples highlighted a need to consider further how the approach would apply to revenue transactions in which:

- customers are not expected to exercise all rights under the contract, or
- non-refundable up-front fees (such as loan origination fees) are paid to access another service or right.

The boards considered an example involving statutorily imposed obligations (such as warranties that goods sold are fit for a particular purpose). The boards decided that such obligations should be accounted for in the same way as any other contractual obligations. However, they acknowledged that, in practice, those types of obligations may be immaterial or inseparable from other obligations within a revenue contract.

Definition of revenues

The boards discussed the circumstances in which transactions for the sale of goods, services or other rights should be treated as generating revenues, rather than other positive components of comprehensive income (such as gains).

The boards had previously decided that the present distinctions between revenues and gains—based on ongoing major or central operations (FASB literature) or ordinary activities (IASB literature)—were somewhat ambiguous and difficult to put into practice.

At this meeting, the boards considered an alternative basis for distinguishing revenues from other positive components of comprehensive income—namely, whether the transactions involved items produced or purchased by the entity for the purpose of sale or resale. They decided this proposed basis was sufficiently promising to merit further investigation and asked the staff to explore it further.

The staff noted that the question of whether production activities preceding entry into contracts with customers could give rise to revenues would be considered at a future meeting.

Short-term convergence: taxes

The boards considered two issues:

(a) uncertain tax positions and

(b) the effect of using the undistributed rate to measure tax assets and liabilities for entities that regard themselves as tax-exempt because of tax deductions available on distributions.

On uncertain tax positions, the boards confirmed their desire to arrive at converged requirements. They noted that the FASB's redeliberation of its proposals following the comments on its draft Interpretation and the IASB's development of its proposals for inclusion in its forthcoming exposure draft would give the boards the opportunity to explore possibilities for a converged answer.

On the effect of using the undistributed rate to measure tax assets and liabilities by entities that regard themselves as tax-exempt, the boards expressed concern about the conclusions presented by the staff. They asked the staff to explore the following alternatives:

- keep the proposed requirements, noting that an entity that committed to making a distribution would recognise the distribution and the related deduction.
- create a definition of an 'in-substance tax-exempt entity' that would cover entities whose tax structure is set up to avoid subjecting shareholders to double taxation and that involves tax deductions being available if the entity distributes all or almost all of its total taxable income.
- require a 'point in time' analysis of whether an entity has the ability to qualify as effectively tax-exempt, in which case it would be treated as tax-exempt. Disclosure would be required of why such an entity qualifies and what it has to do in the future to continue to qualify.
- allow the effects of a distribution outside the entity to be included as a tax planning strategy in determining whether the recovery of an asset or settlement of a liability has taxable consequences, and hence whether a temporary difference exists.

Financial instruments

At the joint meeting in April 2005, both boards expressed the view that adopting a single measurement attribute, fair value, would improve financial reporting and significantly simplify their accounting standards. At that meeting, however, board members differed in their views about whether that solution is attainable in the near future.

At this meeting, the boards established three objectives for improving financial reporting for financial instruments to help the boards evaluate and prioritise future projects on financial instruments. One long-term objective is to require all financial instruments to be measured at fair value, with realised and unrealised gains and losses recognised in the period in which they occur. The Board noted that fair value measurement would produce more relevant information and solve many problems caused by using different measurement attributes for different instruments. However, a number of issues remain to be resolved before the boards could establish such a requirement. Some of those issues include which instruments and related assets and liabilities should be subject to the requirement, how to estimate fair value for instruments that are not traded or are traded in government-controlled or illiquid markets, how to present the components of the net changes in fair values, and what information to disclose about past changes in fair values and exposures to future changes in market factors.

Another objective the boards established is to simplify requirements for hedge accounting and, if possible, reduce or eliminate the need for special accounting. A third objective is to develop a common standard for derecognition of financial instruments that is simpler, easier to apply, and more consistent with concepts of financial reporting than any existing derecognition standard.

The boards directed the staff to prepare material to be posted to each board's Website (a) to inform constituents of the board's objectives, (b) to explain the reasons why those objectives were established, (c) to describe the nature and status of the work that remains to be done before the objectives can be achieved, and (d) to summarise the work currently under way to address financial instruments issues. Additionally, the boards asked the staff to prepare an article that contains a detailed explanation of why fair value is the most relevant measurement attribute for all financial instruments.

As part of the project to address how to present changes in fair values, the boards also discussed possible methods that could be used to disaggregate the changes in fair value of financial instruments, which would be included in a future due process document on disaggregation. The boards decided that classifying changes in fair value as operating or financing and recurring or non-recurring should be considered as part of the performance reporting project. The boards also decided that they would require disclosure of the total changes in fair value for each type of instrument and the cash receipts and cash payments for each type of instrument, as well as information about the relative subjectivity of estimated changes in fair value. The staff will provide more specific recommendations about those disclosures at future board meetings.

Finally, the boards directed the staff to seek the views of users of financial statements about the information that those users would find relevant with regard to past changes in fair value of financial instruments, exposures to future changes in market factors, and how they might use that information.

Conceptual Framework

The boards continued their deliberations on developing a common conceptual framework. They discussed four matters and made the following decisions:

- The process for using qualitative characteristics of accounting information in developing standards for decision-useful financial reports. The boards discussed how best to illustrate the process for resolving issues raised by relationships between qualitative characteristics and directed the staff to draft qualitative characteristics concepts.
- Whether the objectives and qualitative characteristics need to differ for particular types of entities. The boards concluded that there is no need to modify the objectives of financial reporting or qualitative characteristics of decision-useful financial reporting for any types of private sector entities. Cost/benefit constraints will be considered in November 2005. The boards acknowledged that there might be differences in how some qualitative characteristics are applied.
- Objectives for Financial Reporting staff draft. The boards gave the staff drafting directions, including the following:
  - The staff should not develop an appendix about the environmental context of financial reporting and the characteristics and limitations of financial reporting.
  - In the objectives portion, the key concepts will not be highlighted using the black letter/grey letter format of the IASB's standards. The staff should consider other techniques (for example, side-headings and summaries) and how this might affect other phases.
  - The objectives will be described as those of financial reporting rather than of financial statements.
- Project status and plans, including due process. The boards decided that the first due process document for the objectives of financial reporting and qualitative characteristics of accounting information will be an Exposure Draft.

Meeting dates: 2005

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

10 and 11†; 14—18 November

12—16 December

2006

23—27 January

20—24 February

27—31 March

† Includes a meeting with the Standards Advisory Council