IASB

BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

UPDATE

September 2005

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

- Financial instruments puttable at fair value (and instruments with obligations arising on liquidation)
- Revenue recognition
- Classification of contracts settled in own equity denominated in a foreign currency
- Consolidation (including special purpose entities)
- Introduction to International Valuation Standards
- Agenda proposal – Emissions trading
- Short-term convergence: income taxes
- Short-term convergence: earnings per share
- Short-term convergence: segment reporting
- Agenda proposal – Fair value measurement
- Disaggregation of changes in fair value of financial instruments
- Conceptual Framework
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Financial instruments puttable at fair value (and instruments with obligations arising on liquidation)

This project initially focused on the classification under IAS 32 *Financial Instruments*: *Presentation* of financial instruments that are puttable at the fair value of residual interest in the issuer ('financial instruments puttable at fair value'). At its meeting in March 2005, the Board asked the staff of the New Zealand Financial Reporting Standards Board (NZ FRSB) also to consider the classification of shares in limited life entities, and partnership interests and non controlling interests that are puttable at fair value.

Staff of the NZ FRSB presented proposed amendments to IAS 32 related to the classification of:

- instruments puttable at a pro rata share of the fair value of the issuer ('puttable at fair value');
- instruments entitling the holder to a pro rata share of issuer's net assets, payable upon liquidation of the issuer, when liquidation is certain (affects limited life entities);
- instruments entitling the holder to a pro rata share of issuer's net assets, payable upon liquidation of the issuer, when liquidation is at the option of the holder (affects partnership interests); and
- non controlling interests in a consolidated group, when the non controlling interests are puttable at fair value or payable on liquidation (and liquidation of the subsidiary is certain or at the option of the holder).

At present, those instruments are classified as financial liabilities in accordance with IAS 32. Under the proposed amendments, the instruments would be classified as equity in limited circumstances.

The Board decided to proceed with the short-term project to amend IAS 32 to reclassify from liabilities to equity, in limited circumstances, a particular class of instruments. This class would represent a residual interest in the issuer, eg the instruments are the most subordinated class of instruments and payments to the holders are not limited or guaranteed either before or on liquidation.

Staff intend to present any remaining issues arising from the proposed amendments to IAS 32 at a future Board meeting.

Determining whether a share puttable at the fair value of the residual interest in the entity should be split into an ordinary share and a put option

As part of its deliberations on a possible amendment under which such shares would be classified as equity, the Board directed the staff to consider whether a puttable share should be split into an ordinary share and a written put option with an exercise price of fair value.

The Board concluded that conducting further research into an approach that splits a puttable share into an ordinary share and a put option would duplicate efforts of the longer-term project on liability/equity. Consequently, the Board decided not to proceed in determining whether a puttable share should be split into an ordinary share and written put option component.

Revenue recognition

The Board is conducting a project jointly with the US Financial Accounting Standards Board to develop a conceptual model for revenue recognition and a general standard derived from that model.

The model the Boards are considering is one in which the entity recognises revenue on the basis of changes in assets and liabilities resulting from contracts with customers. The entity recognises revenue when it discharges its contractual obligations to supply goods, services or other rights to a customer. The first steps in applying this model are to identify the entity's contractual rights and obligations and to measure the resulting assets and liabilities.

The Board tentatively decided that, at a conceptual level, non-financial liabilities should be measured at fair value, ie the amount the entity would have to pay another business to take over the liability. However, it acknowledges that it can be difficult to measure reliably fair values for many performance obligations. Therefore, the Board decided to explore an alternative approach that would measure the liabilities based on the amount received or receivable from the customer for fulfilling them.

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ISSN 1474-2675

At this meeting, the Board discussed how such an approach should be applied and decided that:

- a single contract may give rise to several different performance obligations that the entity may discharge at different times (eg delivery and servicing of goods). Such contracts should be disaggregated and each performance obligation should give rise to revenue. Revenue from each performance obligation should be recognised when that obligation is discharged.
- contracts should be disaggregated from the customer's perspective. Therefore, performance obligations should be identified as separate components when they provide 'utility to a customer'. Utility to a customer means that the good, service or other right underlying the performance obligation is, in and of itself, fit for some purpose or serviceable for some end.
- a future accounting standard based on this model should set out criteria, or indicators, for identifying the separate components that have utility to the customer. One indicator should be that the component is sold separately (or as an optional extra) by any seller or could be re-sold separately by the customer. Another indicator should be that the entity has an unconditional obligation to stand ready to provide goods, services, or other consideration if a specified event occurs. (Such stand-ready obligations would include warranties and financial guarantees.) The Board suggested that there may be other indicators that should be included.
- each of the performance obligations should be measured by allocating to it a share of the total consideration received or receivable from the customer under the contract. In general, the allocation should be made by reference to the 'customer-based value' of the obligation, ie the price at which the underlying good, service or other rights is, or is capable of being, sold on a stand-alone basis to a customer. Any residual (ie difference between the aggregate of the customer based values and the total contract consideration) should be allocated to the obligations on a pro-rata basis.
- the customer-based value for each component should be measured by reference to the most reliable available evidence. Evidence should be ranked according to the following hierarchy (from most reliable to least reliable): (i) current sales prices charged for that component by the entity itself in an active market; (ii) current sales prices charged by other entities (ie competitors) in an active market; (iii) current sale prices charged by the entity in an inactive market; (iv) estimates of sales prices using entity inputs that reflect the entity's own internal assumptions and data.
- Although most performance obligations should be measured by reference to a customer-based value as described above, exceptions should be made for unconditional stand-ready obligations and recognised liabilities that other IFRSs require to be measured at fair value. These obligations should be measured at fair value and no residual should be allocated to them.
- the staff should explore for further consideration by the Board a modified version of the above model. The modification would be to permit or require entities to measure at fair value all performance obligations for which an active market exists.

Classification of contracts settled in own equity denominated in a foreign currency

IAS 32 requires a derivative contract to be classified as a financial asset or financial liability if it will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. In June 2005 the Board decided to explore a limited scope amendment to IAS 32 that would permit contracts to be classified as equity if they will be settled by an entity by delivering a fixed number of its own equity instruments for a fixed amount of cash or another financial asset denominated in a foreign currency. Such contracts would include the conversion option in a foreign currency denominated convertible bond.

At this meeting the Board noted that the proposed amendment would result in equity and foreign exchange features whose values are interdependent being recognised in equity. The Board observed that excluding from equity the value attributable to the foreign exchange features would require arbitrary rules. The Board also noted that allowing dual indexed contracts (to share price and foreign exchange rates) to be classified as equity would require additional and detailed guidance to avoid structuring opportunities aimed at obtaining a desired accounting result. The Board decided not to proceed with an amendment.

Consolidation (including special purpose entities)

The Board discussed the timing of the recognition of an asset owned directly or through an option in an entity holding that asset. The Board agreed that the relationship between the definition of the reporting boundary and the accounting for an interest in an asset is important. In particular, it is important to identify the circumstances in which the rights conveyed by an option are sufficient to require an entity to prepare consolidated financial statements but are not sufficient to allow the recognition of the asset underlying that option in the individual or separate financial statements of that entity. The discussion also indicated that there may still be some confusion among constituents about the nature of individual and separate financial statements.

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

The staff presented illustrative examples of the accounting for the attribution of profits or losses in the context of potential voting rights. The examples were based on an option to acquire shares in an entity from a third party.

The staff proposed that, although options might be important in determining that an entity is a subsidiary of another, the allocation and accounting for profits and losses of the subsidiary should be allocated to the parent and non-controlling interests based on present ownership interests.

The staff rejected an approach in which the accounting is based on a hypothetical exercise of potential voting rights, ie as if the options have been exercised.

The Board decided that, on consolidation:

- the shares over which the option related are recognised as the non-controlling interest in the subsidiary;
- any option premium reduces the carrying amount of the non-controlling interest;
- the group does not recognise any increase in the fair value of the option during the exercise period, because the consideration for the subsidiary was established at the date control was established;
- on exercising the options, any non-controlling interest is transferred to the controlling interest.

The Board also decided that a group that is consolidated as a result of an out-of-the-money option might recognise profits or losses during the period the option is exercisable, even if the option lapses and the non-controlling interests are derecognised.

Introduction to International Valuation Standards

The Board held an educational session on International Valuation Standards. The session was led by representatives of the International Valuation Standards Committee. The materials for the presentation are in the observer notes for this meeting at: http://www.iasb.org/meetings/sept2005.asp. No decisions were made.

Agenda proposals

The Board considered adding the following topics to its agenda:

- how entities should measure the fair value of assets and liabilities, and
- accounting for emission trading schemes.

The Board considered both topics in the context of its agenda-setting criteria set out in paragraphs 52-61 of Due Process of IASB: Draft Handbook of Consultative Arrangements published for comment in April 2005.

Fair value measurement

The Board decided to add this topic to its agenda. The aim of the project is to provide guidance to entities on how they should measure the fair value of assets and liabilities. The Board emphasised that this project would not change when fair value measurement is required by IFRSs, only how fair value should be determined when a standard requires a fair value measurement. The Board noted that the FASB is nearing completion of its project on fair value measurements, its Statement is expected to be released later this year.

In reaching this agenda decision the Board considered the confusion that exists amongst constituents as a result of the lack of consistent, integrated guidance in IFRSs on fair value measurements.

Because of the urgent need for clear, consistent guidance on fair value measurements in existing IFRSs and the desire to issue a Standard on fair value measurements as close as possible the issue date of amended IFRS 3 *Business Combinations,* the Board decided on the following approach to the project.

- The Board will issue the FASB's final Statement on fair value measurements as an IASB Exposure Draft with an Invitation to Comment. The appendices in the FASB document dealing with consequential amendments and references to US pronouncements will be replaced with proposed consequential amendments to IFRSs. The Board decided that these consequential amendments should be limited to places where Standards explicitly mention fair value and for which the measurement objective is fair value. The Board also decided that no other changes to the wording of the FASB's document should be made in the Exposure Draft. Instead, the Invitation to Comment should identify any areas where the Board disagrees with the FASB's document and ask constituents for their views.
- Before publishing the Exposure Draft and Invitation to Comment, the Board will be briefed on and discuss the FASB document in order to identify issues that should be included in the Invitation to Comment.
- After the comment period for the Exposure Draft has expired, the Board will debate the issues identified by the Board and constituents, and make any required changes to the Exposure Draft before issuing an IFRS.
- Through comments received from constituents and additional research, the staff will identify implementation issues faced by the Board's constituents, including issues related to developing fair value measurements in emerging and transition economies. The staff will then develop appropriate implementation guidance to include in the IFRS on fair value measurements.

Emissions trading

The Board decided to add this topic to its agenda. Rather than a new IFRS, the output from the project is expected to be amendments to existing Standards, so that they better address the main accounting issues raised by emission trading schemes.

In reaching its decision to add the topic to the agenda, the Board noted in particular the increasing international use (or planned use) of schemes designed to achieve reduction of greenhouse gases through the use of tradable permits. It also noted that there was a risk of diverse accounting practices for such schemes following the withdrawal of IFRIC 3 *Emission Rights* and that this would impair the comparability and usefulness of financial statement information.

The Board noted that the emissions trading project would interact with its current project to revise IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. Accordingly, the Board decided first to consider the treatment of permits and licences (including emission rights) issued to entities by government for less than fair value as part of its IAS 20 project. Once it issues an exposure draft of amendments to IAS 20 it will consider other issues relating to emission trading schemes, for example the subsequent accounting for emission allowances and credits.

Short-term convergence: income taxes

The Board considered two issues:

- uncertain tax positions and
- special deductions.

Both issues addressed uncertainty relating to income taxes: uncertain tax positions addresses uncertainty in the amounts underlying current and deferred tax, and special deductions addresses uncertainty in the rates to apply in measuring deferred tax.

The Board made the following decisions:

- in respect of current tax, the entity has a stand-ready liability to pay but the amount is uncertain. Consistent with the approach in the proposed amendments to IAS 37 on recognition, no probability threshold should be applied to the recognition of the stand-ready liability. Rather than adopting an IAS 37 settlement value measurement objective within the constraints of the objectives of IAS 12, the Board decided on an expected outcome measure (ie the probability weighted average of the possible outcomes).
- in respect of deferred tax, uncertainty could exist in both the amount of the underlying deferred tax balances and the tax rates expected to apply. As with current tax, no probability threshold should be applied to the recognition of additional (or reduced) deferred tax. An expected outcome measure determined by the probability-weighted average of the possible amounts and possible rates should be used. The expected rates should be based on rates substantively enacted at the balance sheet date. Only adjustments related to the level of income (eg graduated tax rates) and to the type of income (eg the use of different rates depending on the entity's activities should be anticipated). Other possible deductions or rate differences should not be anticipated.
- the proposed amendments to IAS 37 included consequential amendments to the disclosure of uncertainties relating to income taxes. Those disclosures should be retained.
- the SFAS 109 valuation allowance approach to the recoverability of deferred tax assets should be adopted, replacing the 'affirmative judgement' approach in IAS 12.

The Board noted that the decisions described in first three bullet points above created divergence from the FASB draft Interpretation on uncertain tax positions and the US GAAP treatment of special deductions. The Board asked the staff to develop a paper for the joint IASB/FASB meeting in October so that the boards could discuss the issues together.

Short-term convergence: earnings per share

The Board considered a change to the treasury stock method that will be proposed by the FASB in its Exposure Draft on earnings per share, in October 2005. The proposed change to the treasury stock method would create requirements that diverge from those in IAS 33 *Earnings per Share*.

The term treasury stock method refers to the method of including options, warrants and their equivalents in the calculation of diluted earnings per share (EPS) in SFAS 128 *Earnings per Share* and in IAS 33. In relation to instruments recognised as liabilities for financial reporting purposes and potentially settled in shares, the FASB's draft Exposure Draft proposes that extinguishment of the liability is included as assumed proceeds when calculating the dilutive effect on EPS options, warrants and their equivalents. The change proposed by the FASB affects only instruments that are recognised as liabilities and potentially settled in shares. The FASB decided not to extend its proposal to convertible instruments, until issues of balance sheet classification that are under study in the project on liabilities and equity are resolved.

The Board decided that it would debate the FASB's proposals during the comment period after the FASB Exposure Draft is published. The Board will also consider whether to expose a similar proposed amendment to IAS 33 depending on the outcome of that debate the FASB's due process, and the finalisation of the change in a FASB Standard.

Short-term convergence: segment reporting

The Board discussed the main issues raised by Board members on the first pre-ballot draft of the proposed IFRS on segment reporting. The Board decided the following:

- To retain the title of 'Segments' for the proposed IFRS on segment reporting.
- To have its Plain English Group consider the wording of the objective paragraph in the context of the general structure of IFRSs.
- To amend the scope of the proposed IFRS to include both
  - entities that have filed, or are in the process of filing, their financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market, and
  - entities that hold assets in a fiduciary capacity for a broad group of outsiders (such as banks, insurance companies, securities brokers/dealers, pension funds, mutual funds or investment banking entities).
- To delete the proposed requirement to disclose impairment by segment.
- To add 'material items of income and expense in accordance with paragraph 86 of IAS 1' as a required segment disclosure.
- That the proposed IFRS should not have a separate appendix for defined terms, because it has only one term that is already defined in the text of the standard.
- That the proposed IFRS should include the FASB's basis for conclusions on SFAS 131 as an appendix to the basis for conclusions on the proposed IFRS.

The Board also discussed the comments from the Accounting Standards Board of Japan (ASBJ) on the first pre-ballot draft of the proposed IFRS. The Board confirmed that it wished to proceed with the management approach as set out in SFAS 131.

Disaggregation of changes in fair value of financial instruments

At their joint meeting in April 2005, the IASB and FASB decided to address issues related to reporting fair values of financial instruments. Two major issues were identified for this joint project: disaggregation of changes in fair value and the potential scope of standards related to fair value of financial instruments.

At this meeting, the Board considered the first of these issues - the disaggregation of changes in fair value. The Board discussed whether requiring some form of disaggregation would provide decision-useful information for the users of financial statements. The Board concluded that some types of disaggregation would provide relevant information to users - for example, changes in fair value resulting from cash flows. However, the Board questioned whether requiring disaggregation by some other possible methods would provide relevant information. The Board also noted that disaggregation could occur at an individual instrument level or across a class of instruments.

The Board asked the staff to identify methods of disaggregation that might provide decision-useful information for discussion by the Board at a subsequent meeting.

Conceptual Framework

The Board continued its deliberations on the joint IASB/FASB conceptual framework project. The Board discussed issues relating to:

- the process for assessing qualitative characteristics of financial information;
- planning issues for the reporting entity phase; and
- planning issues for discussion of prospective financial information.

The Board reached the following conclusions:

- Process for assessing qualitative characteristics of financial information: The Board decided that the refined process chart for assessing the qualitative characteristics of financial information is an improvement over the process chart discussed at the July 2005 Board meeting. Board members raised some concerns about the staff's depiction and discussion of timeliness and the consequences of what happens when a faithful representation of a relevant phenomenon cannot be achieved. The staff agreed to continue work on refining the depiction and description of these characteristics. The Board decided that materiality is a factor that should be taken into account in considering qualitative characteristics, but is not a qualitative characteristic itself. Thus, it should not be treated as a separate step in the process. Finally, the Board suggested that the staff further consider whether the process should be described in a different manner when used by standard-setters, rather than when used in financial statement preparation.
- Planning issue for reporting entity phase: The Board decided to proceed, as planned, to develop a due process document on objectives and qualitative characteristics before concluding (or substantially beginning) work on the reporting entity phase of the project. The Board also approved the project plan for the reporting entity phase.
- Planning issues for discussion of prospective financial information: The Board decided that it should continue with the original plan to issue a due process document on objectives and qualitative characteristics before consideration of prospective financial information. That due process document should indicate that the Board will consider the topic of prospective financial information in the later phase on presentation and disclosure, including the boundaries of financial reporting.

The FASB separately discussed the same issues and reached similar conclusions.

Technical plan

The Board made its quarterly review of its Technical Plan. The Technical Plan sets out the expected timetable over the coming 18-24 months for projects on the IASB's active agenda.

The Board expects to publish the IASB project timetable in an expanded format that will provide more information about the Board's long term plans. The Board also directed the staff to include the projected timing of all due-process documents on individual project web summaries.

The Board expects these changes in communication to begin to appear over the next quarter.

Meeting dates: 2005

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

17—21 October

24—25 October (joint with FASB) Norwalk, Connecticut, USA

10 and 11†; 14—18 November

12—16 December

† Includes a meeting with the Standards Advisory Council

Draft Technical Correction 1

In accordance with its draft technical correction policy that was published for comment until 30 September 2005, the Board will publish Draft Technical Correction 1: Proposed Amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates—*Net Investment in a Foreign Operation* on 30 September 2005. Draft Technical Correction 1 is an example of the use that the Board plans to make of the technical corrections policy. Draft Technical Correction 1 will have a comment period ending on 31 October 2005. The Board plans to redeliberate both the draft technical corrections policy and Draft Technical Correction 1 at its November meeting, taking into account the comments of respondents to both documents.

Draft Technical Correction 1

PROPOSED AMENDMENTS TO
IAS 21 *The Effects Of Changes In Foreign Exchange Rates*
Net Investment in a Foreign Operation

Comments to be received by 31 October 2005

This draft Technical Correction 1- Proposed Amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates—*Net Investment in a Foreign Operation* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to IAS 21. Comments on the draft Technical Correction should be submitted in writing so as to be received by **31 October 2005**.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence. If commentators respond by fax or email, it would be helpful if they could also send a hard copy of their response by post. Comments should preferably be sent by email to: **CommentLetters@iasb.org** or addressed to:

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BASIS FOR CONCLUSIONS

BACKGROUND

1. In December 2003 the International Accounting Standards Board issued improvements to various Standards, including IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

2. A principle in IAS 21 is that exchange differences arising on a monetary item that is, in substance, part of the reporting entity's net investment in a foreign operation are initially recognised in a separate component of equity in the consolidated financial statements of the reporting entity. Among the revisions to IAS 21 made in 2003 was the provision of guidance on this principle. The guidance required the monetary item to be denominated in the functional currency of either the reporting entity or the foreign operation. The previous version of IAS 21 did not include such guidance.

3. After the revised IAS 21 was issued, constituents raised several concerns (see paragraph BC4).

4. This draft Technical Correction addresses those concerns.

INVITATION TO COMMENT

The International Accounting Standards Board invites comments on the amendments to IAS 21 proposed in this draft Technical Correction, particularly on the questions set out below. Comments are most helpful if they:

(a) comment on the questions as stated

(b) indicate the specific paragraph or group of paragraphs to which the comments relate

(c) contain a clear rationale

(d) include any alternative the Board should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on additional issues related to the draft Technical Correction.

The Board is not seeking comments on matters in IAS 21 other than those set out in this draft Technical Correction.

Respondents should submit comments in writing by **31 October 2005**.

Question 1

Do you agree with the proposals in this draft Technical Correction? If not, why not? What changes do you propose and why?

Question 2

Do you have any other comments on the proposals?

PROPOSED AMENDMENTS TO IAS 21

The Effects of Changes in Foreign Exchange Rates

An entity shall apply the amendments in this [draft] Technical Correction retrospectively with immediate effect.

Net investment in a foreign operation

Paragraph 15 of IAS 21 is amended as follows (new text is underlined and deleted text is struck through). Paragraphs 15A and 15B are added.

15 ~~An~~ <u>A reporting</u> entity <u>or any of its subsidiaries</u> may have a monetary item that is receivable from or payable to a foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, a part of the entity's net investment in that foreign operation and is accounted for in accordance with paragraphs 32 and 33. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

15A For example, a reporting entity has two subsidiaries, A and B. Subsidiary B is a foreign operation. Subsidiary A grants a loan to Subsidiary B. Subsidiary A's loan receivable from Subsidiary B would be part of the reporting entity's net investment in Subsidiary B if settlement of the loan is neither planned nor likely to occur in the foreseeable future. This would also be true if Subsidiary A were itself a foreign operation.

15B An associate may be a foreign operation. A reporting entity or any of its subsidiaries may have a receivable from such an associate that is, in substance, part of the net investment in that foreign operation, if it meets the condition in paragraph 15. A monetary item that is payable to an associate by the reporting entity or any of its subsidiaries shall not form part of the reporting entity's net investment in a foreign operation.

Recognition of exchange differences

Paragraph 33 of IAS 21 is amended as follows (new text is underlined and deleted text is struck through).

33 When a monetary item forms part of a reporting entity's net investment in a foreign operation and is denominated in the functional currency of the reporting entity, an exchange difference arises in the foreign operation's individual financial statements in accordance with paragraph 28. ~~Similarly, i~~<u>I</u>f such an item is denominated in the functional currency of the foreign operation, an exchange difference arises in the reporting entity's separate financial statements in accordance with paragraph 28. <u>If such an item is denominated in a currency other than the functional currency of either the reporting entity or the foreign operation, an exchange difference arises in the reporting entity's separate financial statements and in the foreign operation's individual financial</u>

statements in accordance with paragraph 28. Such exchange differences are reclassified to the separate component of equity in the financial statements that include the foreign operation and the reporting entity (ie financial statements in which the foreign operation is consolidated, proportionately consolidated or accounted for using the equity method). ~~However, a monetary item that forms part of the reporting entity's net investment in a foreign operation may be denominated in a currency other than the functional currency of either the reporting entity or the foreign operation. The exchange differences that arise on translating the monetary item into the functional currencies of the reporting entity and the foreign operation are not reclassified to the separate component of equity in the financial statements that include the foreign operation and the reporting entity (ie they remain recognised in profit or loss).~~

[Draft] Amendments to IAS 28

An entity shall apply the amendments in this [draft] Appendix retrospectively with immediate effect.

A1 In IAS 28 *Investments in Associates*, paragraph 29 is amended as follows (deleted text is struck through):

> 29 If an investor's share of losses of an associate equals or exceeds its interest in the associate, the investor discontinues recognising its share of further losses. The interest in an associate is the carrying amount of the investment in the associate under the equity method together with any long-term interests that, in substance, form part of the investor's net investment in the associate. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate. Such items may include preference shares and long-term receivables ~~or loans~~ but do not include trade receivables~~, trade payables~~ or any long-term receivables for which adequate collateral exists, such as secured loans. Losses recognised under the equity method in excess of the investor's investment in ordinary shares are applied to the other components of the investor's interest in an associate in the reverse order of their seniority (ie priority in liquidation).

BASIS FOR CONCLUSIONS

This Basis for Conclusions accompanies, but is not part of, the proposed amendments to IAS 21.

Background

BC1. This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in the Draft Technical Correction 1 – Proposed Amendments to IAS 21 The Effects of Changes in Foreign Exchange Rates—*Net Investment in a Foreign Operation.* Individual Board members gave greater weight to some factors than to others.

The rationale for the proposed amendments

BC2. The principle in paragraph 32 of IAS 21 is that exchange differences arising on a monetary item that is, in substance, part of the reporting entity's net investment in a foreign operation are initially recognised in a separate component of equity in the consolidated financial statements of the reporting entity. Among the revisions to IAS 21 made in 2003 was the provision of guidance on this principle that required the monetary item to be denominated in the functional currency of either the reporting entity or the foreign operation. The previous version of IAS 21 did not include such guidance.

BC3. The requirements can be illustrated by the following example. Parent P owns 100 per cent of Subsidiary S. Parent P has a functional currency of UK sterling. Subsidiary S has a functional currency of Mexican pesos. Parent P grants a loan of 100 US dollars to Subsidiary S, for which settlement is neither planned nor likely to occur in the foreseeable future. IAS 21 requires the exchange differences arising on the loan to be recognised in profit or loss in the consolidated financial statements of Parent P, whereas those differences would be recognised initially in equity in the consolidated financial statements of Parent P, if the loan was denominated in sterling or Mexican pesos.

BC4. After the revised IAS 21 was issued in 2003, constituents raised the following concerns:

(a) It is common practice for a monetary item that forms part of an entity's investment in a foreign operation to be denominated in a currency that is not the functional currency of either the reporting entity or the foreign operation. An example is a monetary item denominated in a currency that is more readily convertible than the local domestic currency of the foreign operation.

(b) An investment in a foreign operation denominated in a currency that is not the functional currency of the reporting entity or the foreign operation does not expose the group to a greater foreign currency exchange difference than arises when the investment is denominated in the functional currency of the reporting entity or the foreign operation. It simply results in exchange differences arising in the foreign operation's individual financial statements and the reporting entity's separate financial statements.

(c) It is not clear whether the term 'reporting entity' in paragraph 32 of IAS 21 should be interpreted as the single entity or the group comprising a parent and all its subsidiaries. As a result, constituents questioned whether the monetary item must be transacted between the foreign operation and the reporting entity, or whether it could be transacted between the foreign operation and any member of the consolidated group, ie the reporting entity or any of its subsidiaries.

BC5. The Board noted that the nature of the monetary item referred to in paragraph 15 of IAS 21 is similar to an equity investment in a foreign operation, ie settlement of the monetary item is neither planned nor likely to occur in the foreseeable future. Therefore, the principle in paragraph 32 of IAS 21 to recognise exchange differences arising on a monetary item initially in a separate component of equity effectively results in the monetary item being accounted for in the same way as an equity investment in the foreign operation when preparing consolidated financial statements. The Board concluded that the accounting treatment in the consolidated financial statements should not be dependent on the currency in which the monetary item is denominated, nor should it be dependent on which entity within the group transacts with the foreign operation.

BC6. Accordingly, the Board decided to propose an amendment to IAS 21. The proposed amendment requires exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation to be recognised initially in a separate component of equity in the consolidated financial statements. This requirement applies irrespective of the currency of the monetary item and irrespective of whether the monetary item results from a transaction with the parent or with any of its subsidiaries.

BC7. The Board also decided to clarify that an investment by an associate of the reporting entity in a foreign operation is not part of the reporting entity's net investment in that foreign operation. Because the reporting entity does not control the associate's investment, it generally has no ability to control the terms and conditions of settlement of the associate's investment in a group entity.

