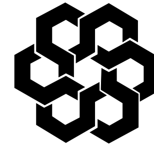

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**October 2008, London**
Project:	**IFRS for Private Entities (formerly IFRS for SMEs)**
Subject:	**Redeliberation - Outstanding Issues (Agenda Paper 5)**

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1. The objective of the discussion at the October 2008 Board meeting is to continue the process of redeliberating the proposals in the ED by addressing some of the issues from past Board papers that have been deferred, for example in areas where further research was being carried out.
2. The issues in this paper have been given the same number as when they were first presented to the Board. Those numbers are based on the section in the ED to which the issue relates. This agenda paper also includes one new issue (Issue 23.2) relating to government grants.
3. The issues are presented in numerical order.

Issue 9.2: Consolidation – temporary control exemption

4. **Reason for revisiting issue.** The Board asked the staff to bring Issue 9.2 back for redeliberation after the Board discussion of the issues relating to Section 36 *Discontinued Operations and Assets Held for Sale*. The Board discussed the Section 36 issues at the September 2008 meeting.
5. **Comment letters.** Allow a temporary control exemption from consolidation.
6. **Field tests.** No related comments.
7. **WG recommendation.** WG members generally did not support adding a temporary control exemption from consolidation because they felt that

circumstances in which a private entity would acquire a subsidiary with the intent to dispose are rare. Moreover, they believe that if consolidation is limited to circumstances in which defined criteria are met (Issue 9.1 of Agenda Paper 2A for the June 2008 meeting), a temporarily held subsidiary would rarely if ever be consolidated.

8. **Staff comment:** IAS 27 *Consolidated and Separate Financial Statements* has a footnote to paragraph 12 that states:

> * If on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, it shall be accounted for in accordance with that IFRS.

Pre IFRS 5, IAS 27 contained an exemption from consolidation on acquisition of a subsidiary if there was evidence that control was intended to be temporary (i.e., there was an intention to dispose of the subsidiary within twelve months and management was actively seeking a buyer). IFRS 5 removed the temporary control exemption. However, the introduction of the 'held for sale' category in IFRS 5 meant that the impact on the financial statements was limited.

9. At the September 2008 meeting the Board decided there should be no 'held for sale' classification for non-financial assets, or groups of assets and liabilities, as is required by IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, and the proposed requirements for assets held for sale in Section 36 should be dropped from the final standard.

10. **Staff recommendation.** Due to the Board's decision to eliminate the 'held for sale' classification, staff recommend adding a temporary control exemption, similar to that previously contained in IAS 27, to avoid having more burdensome requirements for private entities with subsidiaries held on a temporary basis than full IFRSs. Staff agree with the WG that the circumstances in which a private entity would acquire a subsidiary with the intent to dispose are probably rare. However, staff feel that, in this circumstance, private entities should be able to follow a similar accounting to full IFRSs if such transactions do occur. Furthermore, at the June 2008 meeting the Board decided not to provide relief from consolidation in any instances other than in ED paragraph 9.2, which would have reduced the need for a temporary control exemption (see Issue 9.1 from Agenda Paper 2A for that meeting).

Question 9.2

Does the Board agree with the staff recommendation that a temporary control exemption should be added to the requirements in Section 9?

Issue 11.9 (part): Allow purchased options as hedging instruments

11. **Reason for revisiting issue.** Part of the Board discussion on Issue 11.9 was deferred at the June 2008 meeting to allow the staff time to conduct further research on the extent of use of purchased options for hedging purposes by private entities. The other part of Issue 11.9 was concerning whether debt instruments should be allowed as hedging instruments. The Board concluded on this part of the issue at the June meeting.

12. **Comment letters.** Several letters of comment recommended that the Board allow purchased options as hedging instruments. Such instruments would not qualify under ED paragraph 11.32 as drafted. Some respondents said it was common for SMEs have option-based hedging strategies using plain vanilla options.

13. **Field tests.** Very few field test entities performed hedge accounting, which is optional under ED paragraph 11.29. Of those field test entities applying hedge accounting, where details were given, hedging was predominately confined to interest rate or cross currency swaps.

14. **WG recommendation.** The WG considered a short presentation by one of the Board members explaining the rationale for not allowing purchased options as hedging instruments for private entities. Options were not allowed as hedging instruments in Section 11 as it was considered that unless an entity is fairly sophisticated, it is unlikely to use purchased options due to the cost of the premium. The Board member said it was decided to focus only on 'plain vanilla' hedging instruments for simplicity. The main reason for allowing the fallback to full IAS 39 was to allow private entities who have more sophisticated instruments and want to use sophisticated accounting to do so provided they comply with IAS 39 in full. WG members did not feel strongly that purchased options should be allowed as hedging instruments for private entities.

15. **Staff comment.** Here are the requirements of ED paragraph 11.32:

    11.32 This [draft] standard permits hedge accounting only if the hedging instrument has all of following terms and conditions:

    (a) it is an interest rate swap, a foreign currency swap, a foreign currency forward exchange contract or a commodity forward exchange contract that is expected to be highly effective in offsetting a risk identified in paragraph 11.31 that is designated as being the hedged risk.

    (b) it involves a party external to the reporting entity (i.e., external to the group, segment or individual entity being reported on).

    (c) its **notional amount** is equal to the designated amount of the principal or notional amount of the hedged item.

    (d) it has a specified maturity date not later than

    (i) the maturity of the financial instrument being hedged,

    (ii) the expected settlement of the commodity purchase commitment, or

    (iii) the occurrence of the highly probable forecast foreign currency or commodity transaction being hedged.

    (e) it has no prepayment, early termination or extension features.

16. In total, twelve of the comment letters stated that purchased options should be allowed as hedging instruments for private entities. Most of these letters came from national professional accounting associations. Others included standard setters, an international professional accounting firm, a regulator and preparer associations. Most of these comment letters specifically said 'simple' options. The example given most often was private entities use purchased options to hedge forecast foreign currency exposures.

17. To further assess the extent of use of purchased options for hedging purposes by private entities, staff asked WG members and a few financial instrument specialists whether, in their experience, private entities commonly use purchased options for hedging purposes and, if they do, what types of transactions they are used to hedge. Out of those who responded, most noted that they rarely observe smaller private entities using purchased options for hedging purposes. However, such transactions were considered to be quite common amongst larger private entities. A few members of the WG said that although such transactions were rare amongst smaller private entities, if those entities have staff with experience of financial instruments then this kind of activity sometimes takes place. Therefore, in their opinion, to disallow such hedging by small private entities would not be appropriate.

18. **Staff recommendation.** Staff recommend that purchased options should not be permitted as hedging instruments for the reasons outlined by the Board member in paragraph 14 above. Staff acknowledge that some larger private entities may commonly use purchased options as hedging instruments. However, such entities could use full IFRSs, including IAS 39 and full IFRSs may be a more appropriate set of standards for the entity to use if it does have complex transactions and technical expertise. The objective of the IFRS for Private Entities is to cater for typical small private entities who do not engage in complex financial instrument transactions. Staff do not feel that the Standard should be made more complex by catering for those very few small private entities that do have the expertise to enter into such transactions, and can understand and apply hedge accounting properly. In any case, the proposals in the ED would not prevent entities using purchased options to hedge transactions; they would only prohibit applying hedge accounting to those transactions. Neither do the proposals prohibit entities from making additional disclosures, for example, to explain the impact of the purchased option on the financial statements, if they wish to do so.

Question 11.9

Does the Board agree with the staff recommendation that the ED should not be amended to permit purchased options as hedging instruments?

Issue 19.1: Leases – operating, straight-line method

19. **Reason for revisiting issue.** The Board asked the staff to refine its recommendation to modify the application of the straight-line method for operating leases if payments to the lessor are structured to compensate for expected inflation. The revised wording should be more specific and deal with inflation only.

20. **Comment letters.** Do not require the straight-line method for operating leases (spreading total lease payments evenly over the lease term).

21. **Field tests.** No related comments.

22. **WG recommendation.** WG members recommended that the requirement for recognising lease payments under operating leases on a straight-line basis as described in ED paragraph 19.13 be retained.

23. **Staff comment.** ED paragraph 19.13 states:

19.13 A lessee shall recognise lease payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense on a straight-line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

24. **Staff recommendation.** Those who favour the straight-line requirement point out that recognising contractual lease payments as expenses when paid or payable is, essentially cash basis accounting. Moreover, those payments can easily be structured in agreeing on the lease provisions. On the other hand, those who disagree with the straight-line requirement say that leases are often structured with increasing payments to compensate the lessor for anticipated increases in costs of owning and maintaining the leased property. This is structuring for a business reason, not to achieve an accounting result. Staff notes that ED paragraph 19.13 provides for a method other than straight-line if "another systematic basis is representative of the time pattern of the user's benefit". However, comment letters said this is not sufficient grounds to support using a basis other than straight-line where increases compensate the lessor for increases in costs due to inflation because the benefits to the lessee may not change from period to period. Only the lessor's costs change. Staff find this reasoning persuasive. Therefore, staff recommend adding a second 'unless' to ED paragraph 19.13 as follows (note, changes to 19.13 made since the Board debated this issue in July 2008 are shown in underline and using strikethrough text):

19.13 A lessee shall recognise lease payments under operating leases (excluding costs for services such as insurance and maintenance) as an expense on a straight-line basis unless either (a) another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis; or (b) the payments to the lessor are structured to increase in line with expected inflation ~~to compensate for the lessor's expected cost increases~~. If payments to the lessor vary due to factors other than inflation, then condition (b) is not met.

Question 19.1

Does the Board agree with the staff recommendation to revise ED paragraph 19.13 to include the case where payments to the lessor are structured to compensate for the lessor's expected cost increases due to inflation?

Section 21 Equity

Issue 21.1: Classification of equity/liability – different legal forms of entity

25. **Reason for revisiting issue.** This issue has not yet been discussed by the Board.

26. **Comment letters.** The current distinction between equity and liability in Section 21 causes problems since it does not consider the different legal forms of entity within the proposed scope of the IFRS for Private Entities. In particular, Section 21 should address the concerns that what is considered as equity by certain entities is classified as liability under the ED. Various suggestions were made by respondents to achieve what they consider to be the appropriate debt-equity classification for certain types of entities, such as cooperatives and partnerships. An equity definition linked to loss absorption (or participation in losses) was the most common suggestion. A few letters also suggested incorporating the recent

changes made to IAS 32 *Financial Instruments: Presentation* regarding classification of puttable instruments and obligations arising on liquidation (although these were still in exposure draft stage at the time the letters were written).

27. **Field tests.** Several field test entities are partnerships or cooperatives, and most of them noted that, under the ED, they have no equity (because of the rights of partners or members to withdraw their capital), which does not appropriately reflect the fact that the partners and members bear the residual risks and hold the residual interests in the assets of the entity. Several entities said clear guidance on the differentiation between equity and liability is necessary. Some suggested the recent changes to IAS 32 for puttables and obligations arising only on liquidation should be integrated into the IFRS for Private Entities (although these were still in exposure draft stage at the time the field testing was performed).

28. **WG recommendation.** Members of the WG recommended adopting in the IFRS for Private Entities the recent changes made to IAS 32 regarding puttable instruments and obligations arising on liquidation, though they would simplify the wording. Some WG members were unsure if those changes would be sufficient on their own to address the concerns of cooperatives, and they suggested that some research may be appropriate.

29. **Staff comment.** The comment letters on the ED and the reports of the field tests were prepared before the IASB's final changes to IAS 32 were adopted for classification of puttable instruments and obligations arising on liquidation. As a result of the amendments, some financial instruments that had met the definition of a financial liability will be classified as equity because they represent the residual interest in the net assets of the entity.

30. In May 2008, staff sent a short questionnaire to the seven cooperative organisations submitting comment letters on the ED, and to a few other organisations with knowledge of cooperative issues. The questionnaire asked those organisations if incorporating the recent changes to IAS 32 would resolve their concerns about debt/equity classification for cooperatives under Section 21 of the ED and, if not, what further changes they would propose in this area. Only a few organisations replied. Of those that did, respondents noted that the recent amendments to IAS 32 did alleviate some, but not all of their concerns. Respondents noted that that the amendments would not prevent some member shares in cooperative entities being classified as liabilities. However, respondents did not clearly explain why. One respondent noted that the amendment to IAS 32 is too complex for smaller entities to understand and also the detailed wording used does not reflect the business model of cooperatives, e.g., the amendments focus on participation in cash flows and ignore non-cash economic returns of membership.

31. **Staff recommendation.** Staff do not feel there is a persuasive argument for adopting a divergent approach for liability/equity distinction from full IFRSs. Staff acknowledge that some cooperatives issue puttable instruments that do not meet the criteria in the amendment to IAS 32 to be classified as equity. However, the conditions attached to such instruments often vary considerably between different industries and jurisdictions. Staff do not feel that trying to develop a quick fix solution to cater for all these instruments is appropriate, or possible. Staff note that in July 2008 the Board moved its project on reporting requirements

for financial instruments with characteristics of equity from its research agenda to its active agenda. Staff do not feel they should try to anticipate the future changes from this project in order to provide a different treatment for private entities. The Board's comprehensive project will ultimately change the requirements for equity/liability classification under both full IFRSs and the IFRS for Private Entities.

32. Staff therefore recommend adopting in the IFRS for Private Entities the amendment to IAS 32 regarding puttable instruments and obligations arising on liquidation. However, in order to make sure it is understandable to smaller private entities, staff recommend that the wording of the amendment to IAS 32 is simplified and examples of instruments that are classified as liabilities rather than equity, are provided. The amendment to IAS 32 contains many detailed rules. Staff acknowledge the detailed rules are added to avoid structuring opportunities. However, staff feel the risk of structuring is significantly lower for small private entities and there is a bigger risk that setting complex rules will lead to misunderstanding and incorrect accounting. Staff feel that the approach of having simplified requirements, supplemented by examples (both in the Standard and via training material), is likely to be better implemented by smaller private entities.

33. The existing paragraph 21.1 in the ED is as follows:

> 21.1 Equity is the residual interest in the assets of an entity after deducting all its liabilities. Equity includes investments by the owners of the entity, plus additions to those investments earned through profitable operations and retained for use in the entity's operations, minus reductions to owners' investments as a result of unprofitable operations and distributions to owners. This section addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments. Section 25 *Share-based Payment* addresses accounting for a transaction in which the entity receives goods or services (including employee services) as consideration for its equity instruments (including shares or share options) from employees and other vendors acting in their capacity as vendors of goods and services.

34. Staff proposes to replace the foregoing paragraph 21.1 with the following four paragraphs:

> 21.1 This section addresses accounting for equity instruments issued to individuals or other parties acting in their capacity as investors in equity instruments. Section 25 *Share-based Payment* addresses accounting for a transaction in which the entity receives goods or services (including employee services) as consideration for its equity instruments (including shares or share options) from employees and other vendors acting in their capacity as vendors of goods and services.
>
> 21.1A. **Equity** is the residual interest in the assets of an entity after deducting all its liabilities. A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Equity includes investments by the owners of the entity, plus additions to those investments earned through profitable operations and retained for use in

the entity's operations, minus reductions to owners' investments as a result of unprofitable operations and distributions to owners.

21.1B. Some financial instruments that meet the definition of a liability are classified as equity because they represent the residual interest in the net assets of the entity:

(a) Puttable instruments that are subordinate to all other classes of instruments are classified as equity if they entitle the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation. A puttable instrument is a financial instrument that gives the holder the right to redeem or repurchase that instrument from the issuer for cash or another financial asset on exercise of the put or is automatically redeemed or repurchased from the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

(b) Instruments, or components of instruments, that are subordinate to all other classes of instruments are classified as equity if they impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

21.1C. The following are examples of instruments that are classified as liabilities rather than equity:

(a) An instrument is classified as a liability if the distribution of net assets on liquidation is subject to a ceiling. For example, if in liquidation the instrument holders receive a pro rata share of the net assets but this amount is limited to a maximum amount (the ceiling) and the excess net assets are distributed to a charity organisation or the government, the instrument is not classified as equity.

(b) A puttable instrument is classified as equity if, when the put option is exercised, the holder receives a pro rata share of the net assets of the entity measured in accordance with the IFRS for Private Entities. However, if the holder is entitled to an amount measured on some other basis (such as local GAAP), the instrument is classified as a liability.

(c) An instrument is classified as a liability if it obligates the entity to make payments to the holder before liquidation, such as a mandatory dividend.

(d) A puttable instrument that is classified as equity in a subsidiary's financial statements is classified as a liability in the consolidated group financial statements.

[Then continue with ED paragraphs 21.2 to 21.12]

Question 21.1

Does the Board agree with the staff recommendation to adopt the amendment to IAS 32 regarding puttable instruments and obligations arising on liquidation, but with simplified wording and additional examples of instruments that are classified as liabilities rather than equity as proposed in paragraph 26 above?

Issue 23.2 (new): Revise definition of government grant

35. **Additional staff issue.** Staff feel that since the 'IFRS for SMEs' model for government grants distinguishes between conditional and unconditional grants, the use of the word 'conditions' in the definition of a government grant could be confusing.

36. **Comment letters.** No related comments.

37. **Field tests.** No related comments.

38. **WG recommendation.** Not discussed.

39. **Staff comment.** At the July 2008 Board meeting the Board decided that the 'IFRS for SMEs' model (as described in paragraphs 23.4 and 23.5 of the ED) should be required for all government grants (Issue 23.1 of Agenda Paper 8A for that meeting) and the option to apply IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* for those government grants not related to assets measured at fair value through profit or loss (paragraph 23.3(b) of the ED) should be removed.

40. The 'IFRS for SMEs' model for government grants as proposed in Section 23 of the ED is based on the model in IAS 41 *Agriculture* for government grants related to biological assets measured at fair value. In Section 23 of the ED, both paragraph 23.1 and paragraph 23.4 use the term 'conditions', but the meaning differs slightly between the two paragraphs, which could be confusing.

    23.1 A government grant is assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions relating to the operating activities of the entity.

    23.4 An entity shall recognise government grants as follows:

    (a) a grant that does not impose specified future performance conditions on the recipient is recognised in income when the grant proceeds are receivable;

    (b) a grant that imposes specified future performance conditions on the recipient is recognised in income only when the performance conditions are met;

    (c) grants received before the income recognition criteria are satisfied are recognised as a liability.

41. The difference between 23.1 and 23.4 is subtle:

    a. The conditions referred to in 23.1 are the eligibility requirements for receiving the grant.

b. The performance conditions referred to in 23.4 are future performance obligations imposed on the entity receiving the grant and, if those obligations are not fulfilled, the grant must be repaid.

42. At its July 2004 meeting, the Board discussed some issues that would arise if IAS 20 was amended by requiring the IAS 41 model, which is currently limited to government grants related to biological assets measured at fair value, to be used for all government grants. The following are two extracts from the July 2004 IASB *Update*:

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

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

43. **Staff recommendation.** In July 2008, the Board decided to require the IAS 41 model for all government grants in the IFRS for Private Entities. Consequently, the potential for confusion in the meaning of ‘conditions’ that the Board noted at the July 2004 meeting could arise in the IFRS for Private Entities. Therefore staff propose deleting the phrase ‘*in return for past or future compliance with certain conditions relating to the operating activities of the entity*’ from the definition of a government grant in Section 23. Staff also propose adding guidance in Section 23 to clarify which transactions with government meet the definition of a grant.

Question 23.2

Does the Board agree with the staff recommendation that the phrase ‘in return for past or future compliance with certain conditions relating to the operating activities of the entity’ should be deleted from the definition of a government grant and additional guidance should be added to Section 23 to clarify which transactions with government meet the definition of a grant?