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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **January 2009, London**

Project: **IFRS for Private Entities (formerly IFRS for SMEs)**

Subject: **Redeliberation – Rewrite of Section 11 (Agenda Paper 12A)**

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1. For the January 2009 Board meeting, the private entities agenda papers are organised as follows:
   - **Agenda Paper 12 –** Overview (this agenda paper)
   - **Agenda Paper 12A –** Rewrite of Section 11 *Financial Assets and Financial Liabilities*
     - **Attachment A –** Rewrite of Section 11A *Basic Financial Instruments*
     - **Attachment B –** First draft of Section 11B *Additional Financial Instruments Issues*
   - **Agenda Paper 12B –** Redeliberation of Issues Relating to Other Sections
2. In June 2008, the Board asked the staff to redraft Section 11 *Financial Assets and Financial Liabilities* and to present a recommendation at a future Board meeting. Among the tentative decisions made by the Board in June were:
   - Restructure Section 11 in two parts with one part (Section 11A) dealing with the simple payables and receivables and other basic financial instruments, and the second part (Section 11B) dealing with the more complex instruments and transactions. A

private entity that has only basic financial instruments would then not need to consider Section 11B.

- Clarify, by giving examples of the types of financial instruments that a private entity is likely to have, that the cost model will be appropriate for the significant majority of financial instruments held by private entities.

3. In December 2008, the Board considered a first draft of Section 11A and decided that changes or clarification were needed in a number of areas including:

- initial measurement of a financial instrument should be at the fair value of whatever is receivable (for an asset) or payable (for a liability);
- need to identify clearly which basic financial instruments cannot be carried at amortised cost; and
- the derecognition requirements for factoring are not appropriate.

The Board asked the staff to present an updated version of Section 11A at the meeting in January, along with a first draft of Section 11B. Those drafts are presented in the two attachments to this agenda paper.

Issues for Board Discussion – Section 11A

4. Staff has identified several issues with respect to Section 11A on which a Board decision is requested.

Paragraph 11A.11 – Initial Measurement

5. In the draft of Section 11A discussed in December 2008, the basic principle for initial measurement of a financial instrument was stated as:

> 11.11 When a financial asset or financial liability is recognised initially, an entity shall measure it at cost (ie the fair value of the consideration given or received) as follows unless there is evidence to suggest that the transaction did not take place at arm's length between willing parties:
>
> (a) When a financial asset is recognised initially, an entity shall measure it at the amount of any cash or cash equivalents paid plus the fair value of any other consideration given to acquire the asset at the time of its acquisition. If payment of the cash or other consideration is deferred, the entity shall measure the financial asset received at the **present value** of the consideration.
>
> (b) When a financial liability is recognised initially, an entity shall measure it at the amount of any cash or cash equivalents received plus the fair value of any other consideration received in exchange for the obligation at the time of its incurrence.

6. Some Board members disagreed with the principle that the initial measurement of a financial asset should be the fair value of the consideration given. They said this would require an entity, for example, to measure the fair value of inventory sold on credit in order to measure the fair value of the account or note receivable. Conversely, they disagreed with initially measuring a financial liability at the fair value of the

consideration received. This would require an entity, for example, to measure the fair value of tangible assets purchased in order to measure the fair value of the account or note payable. Those Board members said this would impose an unnecessary burden on private entities and would also encourage entities to value receivables at the amount they believe the inventory is worth, which could be greater than the cash selling price, leading to a day one loss (impairment of the receivable). Those Board members encouraged the staff to (a) develop an initial measurement principle based on the fair value of the financial asset acquired and (b) state that the fair value of the financial asset would normally be the invoice price.

7. Board members also disagreed with the clause: "unless there is evidence to suggest that the transaction did not take place at arm's length between willing parties". They pointed out that IFRSs in general do not require remeasurement of related party transactions to an arm's length market price and it would be a significant burden for private entities to assess whether transactions took place at arm's length.

8. In developing the principle that is in paragraph 11A.11 of the draft of Section 11A for the January 2009 meeting, staff initially redrafted 11.11A as follows:

> 11.11 When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value, which is normally the invoice price.

9. The Board's decision in June 2008 to split Section 11 into two parts was intended to allow a cost-based measurement to be used as the approach for most financial instruments in Section 11A and fair value as the approach for most financial instruments in Section 11B. The decision was described in *Update* for June 2008 as follows:

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> "to clarify by the use of examples that the cost model will be appropriate for the significant majority of financial instruments held by private entities. The examples should reflect the types of financial instruments that a private entity is likely to have, with clear guidance for the accounting required both at acquisition or when issued and subsequently. A private entity that has no other financial instruments would then not need to consider the remainder of Section 11 dealing with more complex financial instruments transactions".

10. Redrafting 11A.11 in the manner set out in paragraph 8 means fair value must be determined for all financial assets and liabilities ("an entity shall measure it at its fair value"). Moreover, because of issues relating to the time value of money and non-arm's length transactions, invoice price is not necessarily fair value. While Section 11 has guidance for determining fair value, staff believes that requiring a private entity to measure the fair value of each acquired financial asset and each incurred financial liability, and possibly recognising day-one gains or losses, is a burden similar to the issues relating to fair-valuing the consideration paid or received that concerned Board members in December (see paragraph 6 above). Section 11A is intended to have simple requirements suitable for most private entities.

11. The draft of Section 11A before the Board in January (Attachment A) restates the initial measurement principle as follows:

> 11A.11 When a financial asset or financial liability is recognised initially, an entity shall measure it at the transaction price. If payment for the asset is deferred or is

financed at a rate of interest that is not a market rate, the entity shall measure the asset or liability at the present value of the future payments discounted at a market rate of interest.

12. **Staff recommendation.** Staff recommend that paragraph 11A.11 as drafted is used as the initial measurement principle for Section 11A.

<u>Question – Initial Measurement Principle</u>

Does the Board agree with the staff recommendation that the principle for initial measurement of financial assets and financial liabilities should be as drafted in paragraph 11A.11 of Attachment A?

Derecognition and Debt Factoring

13. Several comment letters expressed concern that prohibiting derecognition when there is any significant continuing involvement, as proposed in the ED, may prevent private entities from derecognising certain assets that would be derecognised under full IFRSs, in particular commonly encountered factoring transactions. At the June 2008 Board meeting, the Board decided in response to these concerns that guidance should be added on accounting for factoring transactions (Issue 11.12 at the June 2008 meeting). In the draft of Section 11A discussed in December 2008, the staff presented their proposed requirements for debt factoring. Those requirements were taken from the UK's *Financial Reporting Standard for Smaller Entities* (FRSSE) effective January 2008. Under the staff proposal discussed in December, some factorings (those meeting the criteria in 11.39 of the December 2008 draft of Section 11A) result in derecognition, while others do not. Also, some of those that do not qualify for derecognition would be presented in a 'linked presentation' in the statement of financial position.

14. The Board did not agree with the staff's proposal. Board members had specific concerns about introducing a linked presentation and treating derecognition of factored assets (which the December 2008 draft of Section 11A did not define precisely and which can have a wide variety of terms and conditions) differently from derecognition of other assets.

15. The revised draft of Section 11A in Attachment A sets out derecognition principles for financial assets in paragraphs 11A.32 to 11A.35. Under those principles, derecognition is prohibited if the transferor has any significant continuing involvement with the transferred asset. Paragraphs 11A.36 and 11A.37 explain that the general derecognition principles in paragraphs 11A.32 to 11A.35 apply to factoring and provide guidance for applying 11A.32 to 11A.35 to factorings. However they do not introduce any special derecognition principles or 'relief' for factoring of receivables. Hence it does not respond to concerns in comment letters.

16. **Staff recommendation.** Staff recommends that:

    (a) The Board tentatively approves the approach set out in the draft of Section 11A.

    (b) Staff should contact the Private Entities Working Group with a request for views on whether further guidance or modifications are needed for factoring and, if so, what that guidance or those modifications should be. Staff will judge whether it receives sufficient additional input to justify bringing the issue back to the Board at a future meeting.

<u>Question – Derecognition and Debt Factoring</u>

Does the Board agree with the staff recommendation to approve the approach for derecognition set out in the revised draft of Section 11A in Attachment A, but to reconsider derecognition at a future meeting after the staff have carried out further research on whether special provisions are needed for factoring?

Draft of Section 11A Overall

17. **Staff recommendation.** Staff believe that all of the other changes made to the December version of Section 11A reflect the Board's decisions in December and at previous meetings. Subject to possible modifications based on Board consideration of the two previous issues in this agenda paper, staff recommend that the Board approve the draft of Section 11A that is presented in Attachment A to this agenda paper.

<u>Question – Section 11A Overall</u>

Does the Board agree with the staff recommendation that, subject to possible modifications based on Board consideration of the two previous issues in this agenda paper, the Board approve the draft of Section 11A that is presented in Attachment A to this agenda paper?

Issues for Board Discussion – Section 11B

Draft of Section 11B Overall

18. Section 11B is intended to cover all financial instruments issues other than those addressed in Section 11A. Staff point out that:

(a) Section 11B covers all financial assets and financial liabilities other than those specifically covered by Section 11A.

(b) The initial measurement principle (paragraph 11B.7) is fair value.

(c) The subsequent measurement principle (paragraph 11B.8) is fair value through profit or loss – the only exception being equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments. Such exceptional instruments are measured at cost less impairment.

(d) The hedge accounting requirements are identical to those proposed in Section 11 of the ED.

(e) There are no derecognition principles in Section 11B. The principles in Section 11A are referenced in paragraph 11B.14.

(f) With the exception of disclosures about hedge accounting, all disclosures are in Section 11A since Section 11A applies to all private entities. Those disclosures are referenced in paragraph 11B.26. In September 2008 the Board reviewed the disclosures proposed in the ED section by section and made decisions on modifications. Those decisions are reflected in the disclosures proposed in the current drafts of Sections 11A and 11B.

19. **Staff recommendation.** Staff recommend that the Board approve the draft of Section 11B that is presented in Attachment B to this agenda paper.

Question – Section 11B Overall

Does the Board agree with the staff recommendation to approve the draft of Section 11B that is presented in Attachment B to this agenda paper?

Issue 11.13 (revisited): Option to use IAS 39/IFRS 7 instead of Section 11

20. At the June 2008 meeting the Board decided to remove from Section 11 the option to follow IAS 32, IAS 39, and IFRS 7 in their entirely, in lieu of Section 11. However, the Board will revisit this tentative decision at a future meeting after Section 11 has been revised.

21. Agenda Paper 12B discusses, and requests a Board decision, on the overall question of whether all, some, or none of the 'complex options' in full IFRSs should be available to private entities, either by cross-reference to full IFRSs or by incorporating the principles and guidance in the standard (via an appendix or otherwise). Staff propose that the option for private entities to follow IAS 39 and IFRS 7 in their entirety, in lieu of Section 11A and Section 11B, is discussed together with the other complex options under Agenda Paper 12B.