BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

April 2002

The International Accounting Standards Board met in technical session in London, UK, on 16 – 19 April, when it discussed:

- Business combinations
- Future agenda items
- IAS 19 *Employee Benefits*
- The *Preface to International Financial Reporting Standards*
- Reporting performance
- Share-based payment

The IASB met the UK Accounting Standards Board on 18 April. The two Boards discussed certain aspects of the IASB's projects on share-based payment and reporting performance. No binding decisions were to be made at this joint meeting.

Joint meeting with UK ASB

Share-based payment

The IASB and the ASB discussed various issues being considered by the IASB in its project to develop an International Financial Reporting Standard on share-based payment.

The discussion focused on option pricing models, beginning with issues relating to the inputs to these models (for example, expected volatility, expected dividends, etc). The two Boards then discussed issues relating to the application of option pricing models to employee share options. In particular, the following features of employee share options were discussed:

- there is usually a vesting period, before which the options are not exercisable
- there are usually service and sometimes performance conditions attached to vesting; if those conditions are not satisfied, the options are forfeited in whole or in part
- the options are usually non-transferable.

Reporting performance

The project on reporting performance is a partnership project between the IASB and ASB. The April meeting provided the first opportunity for the Boards to review the project jointly.

The Boards discussed their objectives for the design of the performance statement. A central issue was the extent to which there should be separate categories of performance as opposed to an unstructured format. There was general preference that there should be a structured categorisation based upon (1) operating *vs* financing activities, and (2) income relating to the current period *vs* income arising from revised capitalisations of future performance.

Mixed views were expressed on whether it is desirable (or, indeed, possible) to proscribe specific subtotals. This discussion included the question of whether a definition of 'operating earnings' (or similar) is a desirable outcome from the project. Although there were wide-ranging views on this issue, a general view was that it would be best to take a decision on this at a later stage of the project.

The Boards evaluated the merits of the three performance statement formats that had been under review in previous meetings – namely, the ASB's FRED 22, the IASC Steering Committee's DSOP (Alternative C) and the concepts paper format. Members of both Boards expressed individual preferences among these three alternative formats with many favouring the concepts paper format.

The Boards suggested subjects for future board discussion, including: more complex financial instruments; restructuring costs and other 'exceptional' items; foreign currency translation; presentation of comparative figures; taxes; minority interest; and distributable earnings.

Amendment to IAS 19 *Employee Benefits*

The Board considered an analysis of the responses to the Exposure Draft of an amendment to IAS 19. The Board agreed to proceed with the proposed amendment. It further agreed:

- the basis of conclusions and the press notice accompanying the amendment should state that the Board will consider adding to its agenda a comprehensive review of deferred recognition and the asset ceiling
- to add a paragraph to Appendix C explaining that the amendment did not prohibit the recognition of gains resulting from an increase in the economic benefits available to the entity.

The Board directed the Staff to prepare a ballot draft of the amendment.

Preface to IFRS

The Board discussed the comment letters received to the Exposure Draft of the *Preface to International Financial Reporting Standards*. After considering the responses received from constituents, the Board agreed:

- that IFRSs are designed to apply to the general purpose financial statements of all profit-oriented entities, as defined
- to retain the use of bold and plain typestyles in IFRSs
- that bold type would be used to indicate the main principles
- that paragraphs in bold and plain types have equal authority in Standards approved by the Board

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Preface to International Financial Reporting Standards *(continued)*

- to make conforming amendments to the rubric at the beginning of each Standard.

The Board discussed a proposed final draft of the *Preface*. In that discussion, the Board decided:

- to amend the *Preface*'s references to the IFRIC and the SAC to be consistent with the IASC Foundation Constitution, and to clarify that IFRIC has a non-voting Chairman
- to clarify that IFRSs include Standards and Interpretations approved by the IASB *and* International Accounting Standards and SIC Interpretations issued under the previous Constitution
- to clarify that IFRSs apply to all general purpose financial statements
- to clarify that the IASB intends issue IFRSs that do not contain alternative accounting treatments
- to remove the reference that IFRSs need not be applied to immaterial items
- to clarify steps in the Board's and the IFRIC's due process
- to clarify that consideration will be given to all comments received *within the comment period* on discussion documents, draft IFRIC Interpretations and exposure drafts
- to clarify that the requirements of an existing IFRS that would be affected by proposals in an exposure draft remain in force *until the effective date* of a new IFRS

The Board also agreed to incorporate into the IFRIC *Preface*, when the IFRIC *Preface* is issued, two paragraphs from the IFRIC's Mandate and Operating Procedures.

Business combinations – Phase I

The Board considered an agenda paper on the transitional provisions and effective date that should be included in the Exposure Drafts arising from phase I of the business combinations project.

In relation to the effective date that should be included in the Exposure Drafts arising from phase I of the business combinations project, the Board agreed that:

- the IFRS replacing IAS 22 *Business Combinations*, the revised IAS 36 *Impairment of Assets* and the revised IAS 38 *Intangible Assets* should be applied to all business combinations for which the agreement date occurs on or after the date those Standards are issued, and to any goodwill and intangible assets acquired in those business combinations.
- the IFRS replacing IAS 22, the revised IAS 36 and the revised IAS 38 should, in all other respects, be applied as from the beginning of the first annual reporting period commencing on or after the date those standards are issued. Entities should, however, be encouraged to adopt those Standards early. If an entity adopts the IFRS replacing IAS 22 before the effective date, it should be required to also adopt the revised IAS 36 and the revised IAS 38 at the same time, and vice-versa.

In relation to transitional provisions, the Board agreed that:

- the requirements of the IFRS replacing IAS 22 should be required to be applied prospectively to business combinations after the effective date of the IFRS, with the following two modifications:
  - the recognition, but not the measurement, requirements for negative goodwill in the IFRS should be applied retrospectively. Therefore, previously recognised negative goodwill remaining as a deferred credit in the balance sheet as at the effective date of the IFRS should be derecognised with a corresponding adjustment to opening retained earnings, and
  - the carrying amount of an intangible asset acquired in a business combination before the effective date of the IFRS and recognised as an asset separately from goodwill as at that effective date should be reclassified as goodwill if it is:
    - not separable and does not arise from contractual/legal rights, or
    - an assembled workforce
- the IFRS replacing IAS 22 should prohibit, as from the beginning of the first annual reporting period commencing on or after the date those standards are issued, the continued amortisation of goodwill recognised prior to that date. Instead, goodwill recognised prior to the effective date of the IFRS should be accounted at its then carrying amount for in accordance with the requirements in the IFRS (that is, impairment tested only)
- for equity accounted investments acquired before the beginning of the first annual reporting period commencing on or after the date those standards are issued, the IFRS should:
  - prohibit, as from that date, the continued amortisation of notional goodwill included within the carrying amount of the investment for the purpose of determining the investor's share of the investee's profit or loss
  - require, as from that date, any notional negative goodwill included within the carrying amount of the investment to be derecognised with a corresponding adjustment to opening retained earnings

  The Board also agreed that the IFRS should clarify that notional goodwill included within the carrying amount of an equity accounted investment should not be tested for impairment by applying the goodwill impairment test in the revised IAS 36. Rather, the carrying amount of equity accounted investments should continue to be reviewed for impairment in accordance with the requirements in IAS 36 (and in the revised IAS 36) for impairment testing assets other than goodwill
- the requirements of the revised IAS 36 should be required to be applied prospectively
- the requirements of the revised IAS 38 should be required to be applied to intangible assets recognised before the effective date of the revised IAS 38. However, any reassessment of the useful life of an intangible asset as a result of the initial application of the revised IAS 38, including a reassessment from a finite to an indefinite useful life, should be accounted for as a change in an accounting estimate. Therefore the effect of such a reassessment should be recognised on a prospective basis, and

- the requirements in the revised IAS 38 for subsequent expenditure on in-process research and development acquired in a business combination and recognised separately from goodwill should be required to be applied prospectively to expenditure incurred after the effective date of the revised IAS 38.

The Board also discussed whether it should conduct public hearings after the end of the comment period for the Exposure Drafts. Board members generally agreed that the objective of public hearings should be to discuss with constituents the implementation and other issues the Board would need to address as a consequence of the changes to existing requirements or practice being proposed by an exposure draft. The Board concluded that, given that it has agreed to conduct field visits during the comment period for the Exposure Drafts, it would first consider the results of those field visits and respondents' comments on the Exposure Drafts before deciding whether to conduct public hearings.

Business combinations – Phase II

Application of the purchase method

The Board agreed to move to its active agenda the project on the application of the purchase method. It will be a joint project with the US Financial Accounting Standards Board, with the FASB staff taking the lead role.

The Board considered the treatment of contingencies in an acquisition. It agreed that the staff should explore amending the definitions of contingent asset and contingent liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as follows:

> A *contingent asset* is a present right that arises from past events that may result in a future cash inflow (or other economic benefits) based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.
>
> A *contingent liability* is a present obligation that arises from past events that may require a future cash outflow (or other sacrifice of economic benefits) based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

The purpose of so doing is to make it clear that there is no difference in the population of items regarded as contingent assets and contingent liabilities under US generally accepted accounting principles and under IASs. The purpose is not to change the recognition rules in IAS 37. If the definitions in IAS 37 cannot be reworded (and consequential changes made) without altering the effect of IAS 37, the Board will reconsider its approach.

The Board further agreed that in accounting for items exchanged in a business combination:

- contingent assets and contingent liabilities (as defined above) of the acquiree should be recognised on acquisition at fair value
- contingent consideration should be recognised at the acquisition date at fair value
- subsequent adjustments to the measurement of the contingent consideration classified as liabilities should not be treated as adjustments to the cost of acquisition
- contingent consideration that takes the form of financial instruments that are classified as equity should not be remeasured subsequent to initial recognition
- the exception in paragraph 1(g) of IAS 39, which excludes contingent consideration from the scope of the standard, should be removed
- contingent assets and liabilities that are financial instruments should be remeasured in accordance with IAS 39
- contingent liabilities that are financial instruments but that are outside the scope of IAS 39 and contingent liabilities that are not financial liabilities should be subsequently remeasured at fair value, and
- contingent assets that are not financial instruments should be remeasured in the same way as intangible assets under IAS 38, *Intangible Assets*.

Board members observed that the Board would be considering the measurement date of equity consideration later in this project and that the measurement date of any debt consideration would need to be consistent with that of equity consideration.

Future agenda items

The Board held a preliminary discussion on future agenda items. Although it will consult the partner national standard setters in May 2002 and the Standards Advisory Council in June 2002 before any final decisions are made, the Board's early view was that staff resources could be used to develop further project plans for the following topics:

- *Convergence* – this project would concentrate on topics where one or more partner standard setters and the IASB have standards that are broadly similar but differ in a limited number of areas.
- *Consolidation and special purpose entities* – a project to examine both consolidation policy (including the application of that policy to SPEs) and procedures.
- *Concepts underlying liabilities, equity and revenue* – the Board is aware that a number of projects are affected by perceived or apparent deficiencies in the definitions of liabilities, equity and revenue currently in the IASB *Framework.*
- *Financial Instruments* – the Board wishes to study further the results of the Joint Working Group's draft standard and basis for conclusions *Financial Instruments and Similar Items*. This work would be preparatory to any decisions on how to progress this topic.
- *Accounting and reporting by small and medium-sized entities* – the staff will examine further the various approaches to the perceived problem adopted in other jurisdictions before recommending an approach to the Board.

Work on business combinations (phase II), with respect to the application of the purchase method, has already begun. This project was formally added to the agenda in April 2002.

Reporting performance

The Board continued its discussion of a concepts paper developed by the Staff. In the context of financial instruments, the Board discussed the two primary categories within the performance statement:

- the distinction between operating and financing activities
- the distinction between income relating to the current period and that arising from revised capitalisations of future performance

The Board's discussion of the second of these categories focused on an illustrative example of income components for a fixed interest bond held at fair value. This analysis was intended simply as a starting point for a later, broader analysis of performance reporting for financial instruments. The Board's discussions were tentative, however, and the subject of financial instruments will be returned to at later meetings.

The Board discussed the operating/financing distinction at much greater length. Two conceptually distinct approaches were reviewed.

- The first approach is based upon the nature of the activity in which any given asset or liability is engaged. Specifically, income and expenses arise either on the finance that supports a given level of operation (that is, capital employed) or on the assets and liabilities thereby financed (that is, net assets).
- The second approach is based upon whether or not the intrinsic nature of the asset or liability is financial (that is, this is a definition based upon the 'nature of the item' as opposed to the 'nature of the activity').

The Board decided to adopt the 'nature of the activity' approach because it was regarded as more meaningful to both users and preparers of financial statements.

The 'nature of the activity' approach requires a definition of the debt component of capital employed, because it is the income and expense on this component that is reported as financing. It was agreed that Staff would present a proposed definition of debt to the Board at a future meeting.

Share-based payment

The Board continued its discussion of issues relating to the application of option pricing models to employee share options (these issues were initially discussed earlier in the day at the joint meeting with the UK Accounting Standards Board). To facilitate the Board's discussions of these issues, it was assumed that (a) the IFRS requires the use of an option pricing model to estimate the fair value of options granted to employees and (b) the IFRS requires that estimate to be made at grant date. (The Board also considered the issue of the appropriate measurement date later in the meeting, as explained further below). Based on these assumptions, the Board tentatively concluded:

- with respect to options granted that cannot be exercised during the vesting period:
  - if the entity uses an option pricing model that values European options, such as the Black-Scholes model, no adjustment is required for the inability to exercise during the vesting period, because the model already assumes that the options cannot be exercised during that period
  - if the entity uses an option pricing model that values American options, such as a binomial model, the application of the model should take account of the inability to exercise during the vesting period.
- expected life rather than contracted life should be used in the option pricing model, to take account of the effect of non-transferability.
- some guidance should be given on when it might be necessary to adjust the option pricing model for the possible capital structure effects associated with issuing new shares upon the exercise of the options.

The Board also discussed the treatment of vesting conditions. The Board tentatively agreed that the treatment of vesting conditions should be consistent with the objective of accounting for the services received, as consideration for the issue of shares or options. The Board asked the staff to prepare a worked example of an approach that would incorporate the existence of vesting conditions into the grant date valuation, with that valuation applied to the services received. Under this approach, an expense would be recognised for services received and consumed during each accounting period, and that expense would not be subsequently reversed in a future accounting period even if the shares or options granted were subsequently forfeited because of failure to meet the vesting conditions. Because this approach is different from the approach in the US standard SFAS 123 *Accounting for Stock-based Compensation*, the Board also asked the staff to include in the worked example a comparison of the two approaches. The Board will continue its discussion of this issue at a later meeting.

The Board also considered the issue of the date at which to measure share-based payment transactions. (The Board began its discussion of this issue at its October meeting). Although the discussion focused on the measurement date in respect of transactions involving share options granted to employees, any tentative conclusions reached also would apply to other forms of share-based payment, i.e. transactions with parties other than employees and transactions involving shares (or other equity instruments). The Board tentatively agreed that when the measurement of a share-based payment transaction is based upon the fair value of the shares or options issued (or to be issued) fair value should be estimated at grant date.

Meeting dates: May – December 2002

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

20 – 24 May‡

17 – 21 June – Berlin, Germany†

17 – 19 July

18 – 20 September, Norwalk, Connecticut, USA

23 – 29 October‡

12 – 16 November, Hong Kong SAR, China†

18 – 20 December

† Includes a meeting with the Standards Advisory Council

‡ Includes a meeting with partner national standard-setters

