BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

October 2004

The International Accounting Standards Board met in Norwalk, Connecticut, USA on 18 and 19 October and met the US Financial Accounting Standards Board on 19 and 20 October. The following matters were discussed:

IASB meeting

- Business combinations
- IAS 12 *Income Taxes*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IFRIC matters
- Post-employment benefits
- Small and medium-sized entities

IASB/ FASB meeting

- Conceptual framework
- Income taxes
- Revenue recognition

IASB meeting

Business combinations (phase II)

The Board considered the following convergence issues:

- the fair value hierarchy
- applying the decisions in the Purchase Method Procedures project to combinations by contract alone without the obtaining of an ownership interest.

Fair value hierarchy

The Board decided to include in its forthcoming exposure draft on Purchase Method Procedures those parts of the FASB's *Fair Value Measurement* exposure draft (FVM ED) that are relevant to understanding and applying the fair value hierarchy. The Board decided that including the FASB's material is important for ensuring a convergent application of the hierarchy by IFRS and US GAAP preparers entering into business combinations.

In particular, the Board decided to include in its ED:

- the definition of fair value and additional guidance on 'willing', 'knowledgeable' and 'unrelated parties' in the FASB's FVM ED. The Board noted that the price at which a liability could be exchanged encompasses the amount for which a liability could be settled.
- the guidance on valuation techniques and market inputs included in the FASB's FVM ED.
- the definition of an active market included in the FASB's FVM ED. However, the Board decided to revise the US-based examples of active markets to provide examples of international markets.

This guidance would apply only in accounting for business combinations.

The Board also considered issues to converge with other aspects of the hierarchy in the FASB's FVM ED. The Board decided:

- to replace having 'reasonable access' with 'immediate access' in Level 1 of the hierarchy. *Immediate access* means that an entity could exchange the asset or liability in its current ('as is') condition at the quoted price in that market within a period that is usual and customary for transactions involving such assets or liabilities.
- that the prices in the most advantageous active market should be used in Level 1 in estimating fair values of all assets and liabilities.
- that the fair value of all assets and liabilities should be estimated using bid prices for assets and ask prices for liabilities in an active dealer market.
- that mid-market prices should be used for the matched portion of offsetting positions in an active dealer market.
- to require in Level 3 the use of multiple valuation techniques that are applicable or relevant in the circumstances unless obtaining the necessary information involves undue cost and effort.

The Board noted that the FASB is planning to reconsider many of the issues in the FASB's FVM ED and tentatively indicated its willingness to redeliberate the proposals relating to the fair value hierarchy that will be included in the Purchase Method Procedures ED based on the comments the FASB received on its FVM ED.

Combinations by contract alone without the obtaining of an ownership interest

In June 2004, the Board considered whether the Purchase Method Procedures ED should propose that business combinations by contract alone without the obtaining of an ownership interest (herein referred to as 'combinations by contract') should be accounted for in accordance with the Board's tentative decisions in this project and tentatively concluded that it should.

The Board also decided in June 2004 to consider, before publishing its ED, issues that might arise from applying the decisions in the Purchase Method Procedures project to combinations by contract. The Board considered these issues at the October 2004 meeting.

In doing so the Board took into consideration the comments received in the 75 comment letters received on its ED of *Proposed Amendments to IFRS 3* Business Combinations *Combinations by Contract Alone or Involving Mutual Entities.*

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ISSN 1474-2675

Business combinations (phase II) *(continued)*

The Board decided to include combinations by contract in the scope of the Purchase Method Procedures ED, and that in such business combinations:

- the purchase method of accounting should be applied.
- difficulties in identifying the acquirer are not a sufficient reason to justify a different accounting treatment and no further guidance is necessary for identifying the acquirer for combinations by contract.
- the total amount to be recognised by the acquirer should be the fair value of the business acquired.
- the accounting for goodwill should be the same as for combinations of other business entities.
- the credit side of the entry should be recognised as equity.

IFRIC matters

Final IFRIC Interpretations approved

Scope of SIC-12

The Board considered the IFRIC's amendment of SIC-12 *Consolidation—Special Purpose Entities*, which the IFRIC, at its October 2004 meeting, had unanimously approved for issue. The Board approved the issue of this Interpretation.

Emission Rights

The Board considered this Interpretation, which the IFRIC, at its October 2004 meeting, had unanimously approved for issue. The Board approved the issue of this Interpretation.

Determining whether an Arrangement contains a Lease

The Board considered this Interpretation, which the IFRIC, at its October 2004 meeting, had unanimously approved for issue.

The Board asked the IFRIC to clarify that the Interpretation should be applied to arrangements in which the underlying asset would represent the unit of account in either IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. The Board also asked the IFRIC to highlight in the Basis for Conclusions any differences from EITF Abstract 01-8 *Determining whether an Arrangement contains a Lease*.

Subject to these modifications, the Board approved the issue of the Interpretation.

Short-term convergence – IAS 12 *Income Taxes*

At the September IASB Educational Session on backwards tracing, the Board was informed that in researching the differences between IAS 12 *Income Taxes* and SFAS 109 *Accounting for Income Taxes* on the issue of allocations to shareholders' equity ('backwards tracing'), the staffs identified that it was a subset of a bigger difference between the two standards, namely intraperiod allocation. Intraperiod tax allocation is the process of allocating current period income taxes among the different components of net income, other comprehensive income, and items debited or credited directly to capital accounts. If there were no intraperiod allocation (ie income tax was presented as a single line item), there would be no need to trace backwards. The Board noted that IAS 12 does not have an equivalent to the detailed guidance in SFAS 109 on intraperiod allocation. At this meeting, the Board discussed the intraperiod allocation requirements of SFAS 109 as well as examples of how the allocation works in various scenarios. The Board expressed concern with the allocation methodology prescribed by SFAS 109 and directed the staff to develop a paper outlining alternative allocation methodologies that also address the differences between IAS 12 and SFAS 109 on items that give rise to the requirement to trace backwards.

Short-term convergence: Post-employment benefits

The Board considered three issues:

- the disclosures proposed in the ED of amendments to IAS 19 *Employment Benefits* in the light of the responses received.
- proposals for group plans following its discussion at the September meeting.
- the IFRIC's redeliberation of multi-employer plans in the light of the responses received on IFRIC Draft Interpretation D6 *Multi-employer Plans*.

Disclosures

The Board decided to require the following disclosures as proposed in the ED:

- reconciliations of the changes in plan assets and obligations.
- an analysis of the amounts recognised in the statement of recognised income and expense.
- the effect of the limit in paragraph 58(b) of IAS 19 to the list of components of cost recognised in the income statement.
- information on plan assets by major asset class, but not the expected rate of return for each class of asset.
- a narrative description of the overall expected rate of return on plan assets.
- sensitivity information about medical cost trends rates.
- the amounts for the current period and previous four periods of the present value of the defined benefit obligation, the fair value of the plan assets, the surplus or deficit in the plan and the experience adjustments arising on the plan assets and liabilities, with transitional provisions allowing for a gradual build up of the information.
- contributions expected to be paid during the next financial reporting year.
- an amendment to paragraph 121 of IAS 19 to require the description of the plan to include any past practice or a history of regular benefit increases used as the basis for accounting for the benefit obligation.

In addition, in response to constituents' comments, the Board decided to require disclosure of the cumulative amounts of actuarial gains and losses not recognised in the income statement.

The Board decided that the Basis for Conclusions should emphasise that the sensitivity information about medical cost trends is subject to the requirements of IAS 1 *Presentation of Financial Statements*, and is thus required only if the post-employment medical costs are material. In addition, IAS 1 requires the disclosure of information about key assumptions and key sources of estimation uncertainty.

Group plans

The Board decided that IAS 19 should be amended to require group defined benefit plans that share risks between individual group entities to be accounted for in the separate or individual financial statements of the group entities as follows:

(a) by measuring the plan in accordance with IAS 19 on the basis of assumptions applicable to the plan as a whole (it is assumed that this information will generally be available to the group as a whole) and either

(b) allocating amounts for the plan to individual group entities in accordance with the contractual agreement or stated policy for charging out the net defined benefit cost, if there is such an agreement or policy, or

(c) if there is no such agreement or policy, to the individual group entity that is legally the sponsoring employer for the plan. The other group entities would recognise a defined benefit cost equal to the contribution charged by the group.

The Board also noted that participation in such plans is a related party transaction and instructed the staff to develop disclosures that would meet the requirements in IAS 24 *Related Party Transactions*. These would include the policy for charging contributions across the group, the contributions for the next financial year and the funded status of the plan.

Multi-employer plans

The Board noted a report from the IFRIC that, in the light of the responses to D6, it did not intend to proceed with the proposals in the draft Interpretation. The Board decided to clarify in IAS 19 that:

- if the entity accounts for its participation in the plan on a defined contribution basis in accordance with paragraph 30 because sufficient information was not available to use defined benefit accounting but
- there is a contractual agreement on the distribution of a surplus or funding of a deficit

the contractual agreement gives rise to an asset or liability that should be recognised.

Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

The Board continued its consideration of the first draft of the exposure draft of amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

The main point discussed at the meeting was the notion of a constructive obligation. The Board had previously decided to amend the definition of a constructive obligation to emphasise that the counterparty to the obligation should be able to ‘reasonably rely’ on the entity discharging its responsibilities. The Board had also decided to provide guidance to explain how ‘reasonably rely’ should be understood. At this meeting, the Board considered whether it should align this new guidance with its tentative decision in its Revenue Recognition project to define a contract as a set of promises that a court will enforce. This would have resulted in a constructive obligation being a liability within the scope of IAS 37 only if the courts would enforce the obligation, which has been inferred from the entity’s past actions. The Board concluded that the notion of a constructive obligation should continue to encompass extra-legal obligations. Nonetheless, it directed the staff to revisit the proposed new guidance and the existing examples of constructive obligations in IAS 37 to emphasise that the class of extra-legal constructive obligations would be very narrow.

The Board also decided:

- not to incorporate into the exposure draft the consensus in IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.
- to withdraw paragraphs 48 and 49 of IAS 37, because they conflict with the requirement to measure a stand-ready obligation (ie an unconditional obligation accompanied by a conditional obligation) by considering the expected value of the cash flows associated with the conditional obligation (in cases in which the stand-ready obligation has to be estimated).
- to amend the measurement section of IAS 37 to clarify (i) that a provision should be measured, both initially and subsequently, at the amount that an entity would rationally pay to settle or to transfer the present obligation on the balance sheet date and (ii) that the measurement should reflect a current discount rate.
- to amend paragraph 54 of IAS 37 (which deals with reimbursements) to clarify that a right to reimbursement should be recognised separately as an asset and should not be offset against the related provision.

Financial reporting standards for small and medium-sized entities

The staff reported that over 100 comment letters had been received on the discussion paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* and that the letters had been posted on the IASB’s Website. The staff presented a preliminary analysis of the first 41 letters. All of the comment letters would be included in an analysis to be presented at a future meeting. Because of the short time between the closure of the comment period and the meeting had not allowed a complete analysis to be prepared, the Board discussed some of the main concerns raised by constituents, but deferred any decisions to a future meeting.

Preliminary observations based on the comment letters analysed thus far include:

- Respondents voiced widespread support for the IASB’s developing a separate set of SME standards. Most of the remainder said that the IASB should address the special reporting needs of SMEs directly in IFRSs rather than in a separate set of standards.
- Many respondents questioned the view that full IFRSs should be considered suitable for all entities because (a) SMEs have different types of financial statement users with different information needs and levels of understanding and (b) costs of compliance were likely to outweigh the benefits.
- Most respondents supported the objectives of IASB standards for SMEs as proposed in the discussion paper, although some respondents suggested (a) adding the objective of providing information for management use, (b) adding an explicit objective about comparability, (c) and tailoring the IASB *Framework* to meet the needs of SME users.
- Most respondents agreed that the Board should develop a single set of standards suitable for all SMEs. Other respondents suggested the Board focus on smaller unlisted entities only.
- Although supportive of an objective of protecting minority shareholders, most respondents thought that a requirement to use full IFRSs if just one of an entity’s owners objected to using SME standards was unduly onerous.

- Respondents voiced widespread support for the proposed 'mandatory fallback' requirement that an SME look to full IFRSs if the standards for SMEs do not address a particular accounting recognition or measurement issue.
- However, many respondents disagreed with an 'optional fallback' proposal that would permit an SME to revert to an IFRS treatment if the treatment in the SME version of the IFRS differs from the full IFRS.
- Nearly all respondents supported disclosure and presentation modifications to full IFRSs in IASB standards for SMEs.
- Many respondents disagreed with the IASB's presumption that no modifications would be made to the recognition and measurement principles in IFRSs. They thought that user needs and cost-benefit analyses would likely justify some modifications.

The Board discussed what are 'user needs' in the context of SMEs. The Board noted that although a majority of respondents (so far) supported differences from full IFRSs when they can be justified by reference to 'user needs', no respondents had provided helpful comments describing what those 'user needs' are. The Board expressed discomfort with proceeding with the project without doing more comprehensive research into user needs.

The Board appointed a subcommittee of Board members to consider the analysis of all comment letters. The subcommittee will present its preliminary thoughts at the Board meeting in November and will bring a proposal for the best way forward with this project to the meeting in December.

IASB/ FASB meeting

Conceptual framework

At their joint meeting in April 2004, the IASB and FASB discussed and expressed support for a staff proposal to undertake a joint project that would have as its objective the development of a common conceptual framework—a single framework in which the existing frameworks of the two boards converge and which improves upon them. The boards decided not to make an agenda decision at that time, but instead directed the staff to develop a plan for conducting such a project for discussion at their joint meeting in October.

At their joint meeting in October, the boards discussed the staff plan and both decided to add to their respective agendas a joint project to develop a common conceptual framework that is based on and builds on their existing frameworks. The boards also reached the following tentative decisions about the conduct of the project:

- Initially, the project would focus on concepts applicable to business entities in the private sector. Later, the boards would consider the applicability of those concepts to other sectors, beginning with not-for-profit entities in the private sector.
- The project should be divided into phases, with the initial focus being on achieving the convergence of the frameworks and improving particular aspects of the frameworks dealing with objectives, qualitative characteristics, elements, recognition, and measurement. Furthermore, as the frameworks converge and are improved, priority should be given to addressing issues that are likely to yield benefits to the boards in the short term, ie cross-cutting issues that affect a number of their projects for new or revised standards.
- The converged framework should be in the form of a single document. It should include a summary and a basis for conclusions.

The boards also agreed with a staff proposal to publish an initial communications document. The staff proposed that the document should explain, amongst other things, the purpose and importance of the framework, why the boards wish their existing frameworks to converge, and why those frameworks are in need of improvement. The boards will consider a staff draft of the initial communications document at future meetings. The boards also agreed with a staff proposal to publish a second communications document, in less detail and written for a 'lay audience,' as part of an overall communications plan.

Short-term convergence – Income taxes

The IASB and FASB continued discussions related to the short-term convergence project on income taxes. The topic of the joint meeting was the foreign subsidiary and joint venture exceptions in IAS 12 *Income Taxes* and SFAS 109 *Accounting for Income Taxes*.

At the IASB's meeting in July 2003, it tentatively decided that an entity should recognise the income tax consequences of all temporary differences arising in the consolidated financial statements. It concluded that, in principle, no exception should exist for temporary differences on investments in subsidiaries and associates or interests in joint ventures – domestic or foreign. However, at that meeting the IASB noted that there might be practical considerations with foreign subsidiaries and foreign joint ventures and directed the IASB staff to analyse these practical difficulties.

On 27 July 2004, the FASB directed its staff to conduct additional research on the practical and cost-benefit considerations of eliminating some exceptions in SFAS 109 to comprehensive recognition of deferred taxes. The primary focus of the research was to be on the practical and cost-benefit considerations of computing deferred taxes on unremitted earnings of foreign subsidiaries and joint ventures.

At their meeting in October 2004, the FASB and IASB received from an outside subject matter expert an educational presentation on the US foreign tax credit system as well as an overview of other tax regimes.

The boards then discussed the complexities surrounding the calculation of a deferred tax liability for permanently reinvested unremitted earnings of foreign subsidiaries and joint ventures. Because of the practical complexities in calculating the amount of deferred taxes for such items, the boards decided to retain the exceptions in and IAS 12 and SFAS 109 for the recognition of deferred tax liabilities for certain investments in foreign subsidiaries (or foreign corporate joint ventures). Additionally, in order to achieve convergence, the IASB decided to amend the language in IAS 12 so that it is similar to that in SFAS 109 and APB Opinion No 23 *Accounting for Income Taxes–Special Areas* with respect to unremitted foreign earnings. The boards also requested the staff to evaluate whether improvements could be made to the disclosure requirements surrounding unremitted earnings of foreign subsidiaries and joint ventures.

Revenue recognition

The Boards discussed how guidance in the FASB's Exposure Draft Fair Value Measurements (FVM ED) could be applied in the context of measuring performance obligations in contracts with customers. In applying the principles in the FVM ED to certain examples that have previously been discussed in the Revenue Recognition project, the IASB tentatively decided that:

- in the absence of evidence to the contrary, actual exchange prices (in other than active markets) should be presumed to be consistent with fair value.
- an entity should not be required to consider multiple valuation techniques when performing the evidence to the contrary test.
- in estimating fair values of performance obligations, an entity should consider the credit enhancement that it provides in the transaction (when applicable).
- prices in proposed exchange transactions may be used as market inputs for the purpose of developing estimates of fair value.
- fair value estimates of performance obligations incorporating significant entity inputs may be consistent with the fair value measurement objective.

The IASB discussed but did not decide whether:

- fair values of performance obligations should be estimated by reference to the most advantageous prices that reflect volume discounts generally available to the entity (and to other marketplace participants that have a comparable volume of transactions), without regard to whether the entity chooses to take advantage of those volume discounts.
- a proposed price may be used as a market input for purposes of estimating the fair value of a performance obligation if the entity does not have immediate access to the reference market from which that price is derived.

Joint public education session

Comprehensive business reporting

The FASB and IASB received a presentation on the CFA Institute's forthcoming proposals regarding the development of a comprehensive business reporting model. In 1993, the Association for Investment Management and Research (the CFA Institute's predecessor body) issued *Financial Reporting in the 1990's and Beyond*. The presentation at this meeting was a preview of part of a white paper, which is seen as a successor to one published in 1993.

The discussion provided the boards with an opportunity to discuss the scope of the CFA Institute's project and the directions for financial reporting suggested by the proposals. The CFA Institute's initiative has potentially important implications for the boards' present and future agendas.

The meeting was educational and no technical decisions were made.

Meeting dates: 2004

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

15—19 November†

14—17 December

2005

18—21 January

10 and 11†; 14—18 February

14—18 March

18—22 April (joint with FASB)

16—20 May

20—24; 27 and 28† June

18—22 July

19—23 September

17—21 October (joint with FASB), Norwalk, Connecticut, USA

10 and 11†; 14—18 November

12—16 December

† Includes a meeting with the Standards Advisory Council