BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

March 2007

IASB Update *is published as a convenience for the Board's constituents. All conclusions reported are tentative and may be changed or modified at future Board meetings.*

Decisions become final only after completion of a formal ballot to issue a Standard or Interpretation or to publish an Exposure Draft.

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

- Financial statement presentation
- Business Combinations II
- Annual improvements process
- Conceptual framework
- Leases
- Financial instruments
- Post-employment benefits
- IAS 37 redeliberations
- Update on IFRIC activities
- IAS 33 *Earnings per share*
- Technical plan

Financial statement presentation

The Board discussed three issues:

- the presentation of changes in assets and liabilities
- the presentation of other comprehensive income items
- whether to retain the concept of cash equivalents and, if so, its definition.

Presentation of changes in assets and liabilities

The Board tentatively decided that, in principle, the cohesiveness principle should be applied at the line item level, ie changes in individual line items on the statement of financial position should be linked to similarly classified line items on the statement of comprehensive income and statement of cash flows, to the extent possible. To achieve line item cohesiveness, the Board tentatively decided to consider a reconciliation of beginning and ending statements of financial position. The purpose of this reconciliation would be to provide information that would help investors and other users understand the cause of a change in amounts of assets and liabilities, which is consistent with one of the project's working principles.

The Board tentatively decided that, in determining what information about changes in amounts of assets and liabilities should be disaggregated in the financial statements, it would consider the characteristics of persistence and measurement subjectivity because those are factors that a user of financial statements takes into account in predicting future cash flows. For example, changes related to recurring fair value measurements (as those terms are used in SFAS 157 *Fair Value Measurements*) might be presented separately from other changes in assets and liabilities. The Board will continue at a future meeting its discussion of what types of changes should be disaggregated. A majority of Board members expressed a preference for not requiring use of the direct method of reporting operating cash flows. The Board tentatively decided that if the indirect method is used, a reconciliation of operating income and cash flows from operating activities should continue to be provided.

Presentation of other comprehensive income

The Board resumed its discussion at its meeting in December 2006 of how other comprehensive income items should be presented in the statement of comprehensive income. The Board continues to have a mixed view on this issue. Thus, it tentatively decided that more than one alternative should be included in the discussion document including one that would present OCI items separately from other income and expense items. The staff were asked to develop possible alternative presentations for discussion at a future meeting.

Under most of the presentation alternatives being considered each other comprehensive income item would need to be classified in one of the functional categories (operating, investing, or financing). With the exception of the foreign currency translation adjustment, the Board tentatively decided not to prescribe specific classification guidance for other comprehensive income items. Thus, those items would be classified on the statement of comprehensive income consistently with the classification of the asset or liability that gives rise to them. The Board tentatively concluded that in the statement of comprehensive income, foreign currency translation adjustments related to consolidated subsidiaries and proportionately consolidated joint ventures should be classified in the operating category, and foreign currency translation adjustments related to equity method investments should be classified in the same category as the equity method investment. To achieve the Board's long-term goal of presenting other comprehensive income items in the same manner as all other changes in assets and liabilities, the Board tentatively decided to address the standards that give rise to other comprehensive income items individually and separately, rather than as part of the financial statement presentation project.

Cash equivalents

The Board tentatively decided that the notion of cash equivalents should not be retained in financial statement presentation. The definition of cash in existing literature would be retained and the statement of cash flows would present information on changes in cash only. The Board directed the staff to consider whether net amounts of receipts and payments related to items previously classified as cash equivalents be permitted for presentation on the statement of cash flows. The Board will discuss how financial assets should be presented in the statement of financial position and what related disclosures in the notes to financial statements should be required when it revisits other liquidity disclosure issues.

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Business Combinations II

Contingent consideration

The Board tentatively affirmed that measurement period adjustments (ie adjustments to provisional amounts recognised at the acquisition date) should reflect only new information obtained about facts and circumstances *that existed as of the acquisition date* and, if known, would have affected the measurement of the amounts recognised as of that date. Changes in market conditions after the acquisition date should not be accounted for as measurement period adjustments.

The Board tentatively affirmed the proposal in the exposure draft that an acquirer should measure and recognise contingent consideration at its acquisition-date fair value. An acquirer should classify contingent consideration as either a liability or equity on the basis of other IFRSs. After initial recognition:

- contingent consideration classified as equity should not be remeasured.
- contingent consideration classified as a liability should be remeasured to fair value, unless it is in the scope of IAS 37, in which case it should be measured in accordance with IAS 37.
- changes in the amount recognised for contingent consideration liabilities that do not qualify as measurement period adjustments should be recognised in profit or loss or directly in equity in accordance with other IFRSs.

The Board also tentatively affirmed the following disclosures related to contingent consideration:

- the acquisition-date fair value of any contingent consideration.
- the range of the potential amount of future payments (undiscounted) the acquirer could be required to make under the terms of the acquisition agreement. If there is no limitation on the maximum potential amount of future payments, that fact should be disclosed.
- any changes in the amounts recognised for contingent consideration and in the range of potential payments and the reasons for those changes.
- the valuation techniques used to measure contingent consideration.

Non-controlling interests

The Board continued its redeliberations of the measurement of non-controlling interests (NCI) in a business combination.

In December 2006 the Board tentatively decided that the proposed standard should include the principle that all components of a business combination, including NCI, should be measured at fair value at the acquisition date. In reaching that decision, the Board gave weight to its goal of ensuring that the underlying principles are clearly stated in the standard. Having made a decision in principle, the Board also tentatively decided that there were grounds for making an exception to this principle. In January the Board discussed this matter further, but did not reach a conclusion on how best to proceed. The Board asked the staff to undertake additional analysis on the potential loss of comparability of financial information if either two measurement bases for NCI were permitted in the final standard, or fair value measurement of NCI was not permitted. The Board discussed this analysis at its March meeting.

The Board expressed a preference for having the proposed standard provide relief if measuring NCI at fair value would cause undue cost and effort for an entity. If it would cause undue cost and effort, the acquirer would measure NCI at its proportionate interest in the identified assets and liabilities of the acquiree. In such circumstances, an acquirer would be required to identify and disclose the reasons for not measuring NCI at fair value.

The Board tentatively affirmed that measuring NCI at its proportionate interest in the identified assets and liabilities of the acquiree does not change the nature of subsequent exchanges between controlling and non-controlling interests. Once control has been achieved, any changes in ownership interests (such as subsequent acquisitions or dispositions) between controlling and non-controlling interests are transfers between owners and there should be no adjustment to goodwill. The Board tentatively affirmed that this decision also applies to transactions with non-controlling interests in which the related NCI was recognised before the application of the revised IFRS 3.

Bargain purchases

The Board discussed the measurement of NCI and goodwill when the fair value of the acquirer's interest in the identifiable net assets of the acquiree exceeds the fair value of the consideration transferred for that interest (also known as bargain purchases).

The Board tentatively decided that the existence of a bargain purchase should not change the measurement attribute used for NCI. In other words, an acquirer should measure NCI in a bargain purchase consistently with how it would measure the NCI in the absence of a bargain purchase. The acquirer should compare (i) the acquisition-date fair value of the consideration transferred in exchange for the acquiree plus the recognised amount of the NCI and (ii) the recognised amounts of the identifiable net assets acquired. If (i) is larger than (ii), the excess is recognised as goodwill. If (ii) is larger than (i), the excess is recognised as a bargain purchase gain attributable to the acquirer.

Assembled workforce

In October 2006 the IASB and the FASB reached different conclusions on the recognition of an acquired assembled workforce separately from goodwill in a business combination. Because of this divergence, the Board discussed again whether to require or preclude the recognition of an assembled workforce separately from goodwill.

The Board observed that an assembled workforce would not meet the separability criterion on the basis that it is unlikely that an assembled workforce would be separable with a single related contract, asset or liability. Rather, an assembled workforce could be sold or exchanged only with a group of related assets or liabilities. On this basis the Board tentatively decided that the application guidance of the business combinations standard should define an assembled workforce and explain why it does not meet the separability criterion.

Valuation allowances disclosures

In January the Board asked the staff to conduct further research into whether the proposed standard should require the disclosure of information about the historical performance of receivables acquired in a business combination.

At this meeting the Board considered a possible requirement to disclose for each major class of receivable acquired in a business combination its fair value, gross contractual amounts, and the best estimate of the contractual cash flows not expected to be collected at the acquisition date. The Board tentatively decided to include this disclosure requirement in the final business combinations standard.

Loss of control of a business resulting from a distribution to owners

The Board discussed the accounting for when an entity transfers its shares in a subsidiary to its own shareholders with the result that the entity loses controls of the subsidiary (commonly referred to as a spin-off). The IFRIC had previously discussed this matter, but decided not to take it onto its agenda while the Business Combinations project was in progress.

The Board decided not to address in phase II of the Business Combinations project the measurement basis of distributions to owners. That said, the Board tentatively decided that the revised business combinations standard should clarify that an entity should measure any retained interest in the previously controlled subsidiary at fair value at the date control is lost.

Annual improvements process

The Board discussed seven issues for inclusion in the annual improvements process. This new process is intended to eliminate inconsistencies between standards and to clarify wording. Proposed amendments to standards resulting from the process will be published in a single exposure draft each year. The first group of proposed improvements will be published in October 2007.

Designating and documenting hedges at the segment level

Paragraph 73 of IAS 39 *Financial Instruments: Recognition and Measurement* refers to the need to designate hedging instruments at the segment level. IFRS 8 *Operating Segments* requires disclosure of information that is reported to the chief operating decision maker even if this is on a non-GAAP basis. Therefore, the two standards appear to be in conflict. The Board approved a proposal to remove references to the need to designate hedging instruments at the segment level in paragraph 73 of IAS 39.

Recoverable amount

Recoverable amount is defined in IAS 16 *Property, Plant and Equipment* as the higher of an asset's net selling price and its value in use. The Board approved a proposal to replace the term 'net selling price' in this definition with 'fair value less costs to sell' for consistency with the wording used in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 36 *Impairment of Assets*.

Investment property held under a lease

Paragraph 50(d) of IAS 40 *Investment Property* states that the fair value of an investment property under a lease is determined for accounting purposes by adding back any recognised lease liability. The Board considered this statement misleading because it implied that the fair value of an investment property asset under a lease was equal to the net fair value plus the carrying amount of any recognised lease liability. Therefore, the Board approved a proposal to amend paragraph 50(d) to clarify this wording.

Contingent liabilities

Paragraph 32B of IAS 19 *Employee Benefits* states that contingent liabilities are required to be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This is inconsistent with IAS 37, which states that an entity shall not recognise a contingent liability. Therefore, the Board approved a proposal to remove the reference to recognition.

'Fall due' and 'expected to occur'

The Board discussed a potential conflict between paragraphs 7 and 8 of IAS 19. Paragraph 7 states that compensated absences 'fall due' when the employee has rendered the service. Short-term compensated absences are described in paragraph 8 as benefits 'expected to occur' within twelve months after the end of the period. Other long-term employee benefits are defined as employee benefits that are expected to 'fall due' more than twelve months from the end of the period. Therefore, a compensated absence that is due to the employee but is not expected to occur for more than twelve months is not an other long-term employee benefit as defined in paragraph 7 of IAS 19, nor is it a short-term compensated absence as described in paragraph 8 of IAS 19. In view of the perceived conflict, the Board approved a proposal to amend the definition of short-term employee benefits and other long-term employee benefits to replace the term 'fall due' with 'expected to be settled'. The Board noted that the expected timing of settlement of the benefit is the critical factor in classifying the benefit.

Boundaries of the annual improvements process

Some issues could be resolved by either the annual improvements process or as editorial corrections. The Board discussed issues relating to the introductory paragraphs of IFRS 4 *Insurance Contracts* and the rubric in IAS 19 *Employee Benefits*. The Board decided that, in most circumstances, minor issues relating to material that is not part of a standard can be resolved as an editorial correction.

Restructure of IFRS 1 *First-time Adoption of International Financial Reporting Standards*

Since it was issued, IFRS 1 has been amended several times to accommodate first-time adoption requirements resulting from new or amended standards. Because of the way IFRS 1 is structured, these amendments are making the standard more complex and less clear. In the future, this problem is likely to become worse. At its meeting in February, the Board approved a proposal to improve the structure of IFRS 1 without amending its substance. The proposed revised structure would be clearer and better designed to accommodate future changes.

At this meeting, the Board discussed a draft version of the proposed restructure. There were no objections to the proposal.

Conceptual framework

The Board discussed a draft paper that summarised comments made by participants in the round-table meetings on measurement that were held in January and February 2007. The paper will be distributed to participants and posted on the Website when it is finalised. The Board noted that by publishing the participants' comments, the Board and staff were not making a judgement on the validity of the comments. In the light of input from the round-table meetings, the Board also reviewed and approved changes to the plan for the measurement phase.

Leases

The Board held its first discussions on the lease accounting project. The project is a joint project with the FASB that will lead to a fundamental reconsideration of lease accounting. The first step in the project will be the publication of a discussion paper in 2008.

The Board first discussed a paper that identified the rights and obligations arising in a simple non-cancellable lease contract and analysed whether the rights and obligations identified meet the current definitions of assets and liabilities in the *Framework*.

The Board tentatively concluded that in the simple non-cancellable lease described in the paper, the lessee has:

- a right to use the leased item that meets the definition of an asset; and
- an obligation to make payments that meets the definition of a liability.

The Board tentatively concluded that the lessee's obligation to return the leased item at the end of the lease does not meet the definition of a liability. However, the Board noted that liabilities might exist because of asset retirement obligations or requirements to return the equipment in a specified condition.

In addition, the Board tentatively concluded that in the simple non-cancellable lease described in the paper, the lessor's right to receive payments from the lessee meets the definition of an asset but that the lessor's obligation to permit the lessee to use the leased item does not meet the definition of a liability.

The Board also discussed whether this analysis would be the same if the working definitions of assets and liabilities developed by the conceptual framework team were applied to the rights and obligations identified. The Board tentatively concluded that the answer would be the same.

The Board concluded that the staff should analyse the rights and obligations arising in lease contracts in terms of the existing definitions of assets and liabilities. However, the Board asked the staff to ensure that any possible inconsistencies between the existing definitions and the working definitions are brought to its attention.

The Board then considered a paper on various accounting models for lease accounting. The Board discussed:

- the right of use approach. In this approach, the lessee recognises its right to use the leased item and an obligation to pay for that item. The lessor recognises as an asset its right to receive payments from the lessee and its residual interest in the leased item at the end of the lease.
- the whole asset model. In this approach, the lessee records the whole of the physical item on its balance sheet. To correspond to that asset, the lessee recognises two liabilities—the obligation to make payments to the lessor and an obligation to return the physical item at the end of the lease. The lessor recognises its right to receive payments from the lessee and its right to have the leased item returned at the end of the lease.
- the executory contract model. In this approach, the lessee recognises no assets or liabilities upon entering into the lease contract. Lease rentals are recognised in profit or loss as they become due. The lessor recognises the leased item as an asset.
- the model used in current standards—the lessee either accounts for the lease as an executory contract or recognises an asset and liability depending upon the classification of the lease contract. Lessor accounting similarly depends upon the lease classification.

The Board tentatively concluded that the right of use approach is the only approach that results in the recognition of the assets and liabilities identified in a simple lease. Consequently, the Board directed the staff to develop this model further.

Lastly, the Board noted that there are important issues relating to measurement and recognition that have not yet been considered that might change these preliminary conclusions.

Financial instruments

Due process document

At their joint meeting in April 2006, the IASB and the Financial Accounting Standards Board agreed on a goal of publishing a due process document on financial instruments (as envisaged in their Memorandum of Understanding) by January 2008. The boards agreed that this document would, as far as possible, include the preliminary views of each board.

At previous meetings, the Board discussed an accounting model that would achieve the long-term objective of requiring all financial instruments to be measured at fair value, with realised and unrealised gains and losses recognised in the period in which they occur (the 'fair value' model).

At this meeting, the Board considered different approaches to moving towards the fair value model that might be discussed in the due process document. The approaches discussed included:

- developing an exposure draft of the fair value model; and
- developing and implementing one or more interim steps before requiring the fair value model.

Regarding the latter approach, the Board discussed several criteria that might be used to develop examples of a possible next interim step. The key criteria discussed included requiring more financial instruments to be remeasured at fair value and reducing the complexity of existing requirements.

The Board reached no preliminary views at this meeting.

Post-employment benefits

The Board continued its discussion of the presentation of components of post-employment defined benefit plans. The Board tentatively decided to change its preliminary view to require all changes in the post-employment benefit obligation and in the value of plan assets to be recognised in comprehensive income in the period in which they are incurred, with no preliminary view on presentation. The Board tentatively decided that the discussion paper would discuss the following approaches:

(a) all changes presented in profit or loss

(b) financing costs presented outside profit or loss

(c) remeasurement changes presented outside profit or loss.

The Board noted that some Board members preferred approach (a). The Board asked the staff to develop for further consideration the arguments supporting each approach.

IAS 37 redeliberations

The Board continued its redeliberations of the proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, focusing on distinguishing a liability from a business risk and stand ready obligations.

The Board noted that tackling these issues had wider implications than the IAS 37 project. Most notably, the same issues needed to be resolved as part the Board's work on the definition of a liability in the Conceptual Framework project.

Distinguishing a liability from a business risk

The Board discussed a series of examples developed by the staff to assist in distinguishing a liability from a business risk. The Board noted that a present obligation is an essential characteristic of a liability, but not a business risk. Therefore, discussion focused on explaining when and why a present obligation exists.

The Board tentatively concluded that a present obligation exists when (a) an entity is irrevocably committed to act in a particular way; and (b) an external party has an enforceable right to call upon the entity to act in that particular way. Consequently:

- an irrevocable action or event, by itself, does not give rise to a present obligation. A mechanism that establishes an external party's right to call upon the entity is also required.
- a law (including contract law) or regulation, by itself, does not give rise to a present obligation; an irrevocable action or event is also required. However, laws and regulations are examples of mechanisms that may establish an external party's right to call upon the entity to act in a particular way.
- a revocable (non-binding) action or event in a jurisdiction where there is a mechanism that establishes an external party's right to call upon the entity to act in a particular way does not give rise to a present obligation.
- planning a future irrevocable action or event in a jurisdiction where there is a mechanism that establishes an external party's right to call upon the entity to act in a particular way does not give rise to a present obligation.

As a result of working through these examples, the Board identified that a crucial point was to distinguish a stand ready obligation from a business risk. Therefore, the Board instructed the staff to develop the analysis of the example illustrating this point for further discussion.

Stand ready obligations

Clarifying the notion of a stand ready obligation

In May 2006 the Board confirmed that a stand ready obligation must satisfy the Framework's definition of a liability. At this meeting the Board went on to clarify that the notion of a stand ready obligation describes present obligations whereby an external party has a right to call upon the entity to act in a particular way in the future, but either the circumstances entitling the external party to exercise its right may not arise, or the external party may choose not to exercise its right.

Applying the notion of a stand ready obligation to non-contractual scenarios

At the round table meetings on IAS 37 many participants were comfortable with applying the notion of a stand ready obligation to contracts. However, they were uncomfortable with extending the notion to non-contractual scenarios. The Board noted that because statutes and contracts are simply legal mechanisms that establish an external party's right to call upon the entity to act in a particular way, the form of the mechanism (ie statute or contract) should not influence whether a stand ready obligation exists. As a result, the Board tentatively affirmed that the notion of a stand ready obligation can apply to both contractual and non-contractual scenarios.

The term 'stand ready obligation'

At the round-table meetings on IAS 37 some participants suggested that the Board should drop the label 'stand ready obligation' and simply focus on explaining when and why a present obligation exists. The Board acknowledged that, for some, the label 'stand ready obligation' was confusing, but believed that a short-hand term capturing the long-hand explanation was helpful. The Board tentatively decided to keep the term but asked the staff to consider other phrases or terms when drafting the standard.

Update on IFRIC activities

The staff reported on the IFRIC's meeting in March, details of which are published in IFRIC Update. The IFRIC has made progress on its redeliberations on D19 *IAS 19—The Asset Ceiling: Availability of Economic Benefits and Minimum Funding Requirements* and D20 *Customer Loyalty Programmes*. The IFRIC expected to vote on both documents at its meeting in May and bring them to the Board for approval as Interpretations shortly thereafter.

The IFRIC continued its discussions on sales of real estate and hedging a net investment and will be considering texts for draft Interpretations on each at its meeting in May.

The IFRIC reached final or tentative decisions to pass to the Board four other issues for consideration as part of either the annual improvements process or other projects.

IAS 33 *Earnings per share*

The Board discussed proposals on earnings per share calculations. These proposals replace previous decisions made by the Board relating to proposed changes to the treasury stock method. One of the main focuses of the new proposals is convergence with the Financial Accounting Standards Board (FASB).

Fair value method

Currently, IAS 33 *Earnings per Share* calculates the dilutive effect of options and warrants using the treasury stock method. This method assumes that the proceeds from conversion are used to repurchase shares at the average market price.

Options and warrants classified as liabilities in accordance with IAS 32 *Financial Instruments: Presentation*, are measured at fair value and changes in fair value are recognised in profit and loss. The Board proposes to exclude from diluted earnings per share calculations, options and warrants classified as liabilities. The Board noted that fair value adjustments recognised in the profit and loss better reflect the dilution of earnings relevant to these instruments during the period.

IAS 33 calculates the dilutive effect of convertible instruments using the if-converted method. This method assumes that the instruments are converted at the beginning of the period and reflects the dilution of shares accordingly. Consistently with the proposal to exclude options and warrants classified as liabilities, the Board proposes to exclude from diluted earnings per share calculations, convertible instruments classified wholly (ie both the host and the conversion option) as liabilities and measured at fair value through profit and loss.

Scope issues

The Board also discussed several issues that could be addressed while making the proposed amendments for the fair value method. Of these issues, the Board proposed the following:

- Guidance issued by the FASB on participating securities (Issue 2 of EITF Issue 03-6 and proposed FSP on EITF Issue 03-6-a) would not be incorporated into IAS 33.
- Guidance issued by the FASB on the two-class method (Issues 3 to 6 and 8 of EITF Issue 03-6) and the potential guidance on the application of the two-class method to master limited partnerships would not be incorporated into IAS 33.
- Guidance issued by the FASB on contingently convertible instruments (EITF Issue 04-8) would not be incorporated into IAS 33.
- Paragraph A14 of application guidance in IAS 33 would be amended to state that the conversion of participating securities would be calculated using the two-class method.
- Application guidance and examples issued by the FASB on the two-class method (proposed FASB staff position on FAS 128-a) would be incorporated into IAS 33.
- IAS 33 should be amended to require the two-class method for computing basic earnings per share for mandatorily convertible instruments with a stated participation right. Mandatorily convertible instruments without a stated participation right should be excluded from the calculation of basis earnings per share.
- IAS 33 should be amended to include options and warrants with a nominal exercise price in the computation of basic earnings per share if (a) the instruments are currently exercisable or convertible into ordinary shares for little or no cost to the holder or (b) the option or warrant currently participates in earnings with ordinary shareholders.

Technical plan

The Board made its quarterly review of its Technical Plan.

The Plan sets out the expected timetable over the coming 18-24 months for projects on the IASB's active agenda. The Board publishes the revised timetable on its Website following each review. Updated project summaries are available on the IASB Website at www.iasb.org/Current+Projects

Meeting dates: 2007

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

2007

16—20 April

23—24 April (joint with FASB)

14—18 May

18—22 June

16—20 July

17—21 September

15—19 October

22—24 October (joint with FASB), Norwalk, Connecticut, USA

12—16 November

10—14 December