BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

October 2008

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 13-17 October, when it discussed:

- Credit crisis
- Annual improvements
- Fair value measurement
- Financial instruments with characteristics of equity
- IFRS for private entities
- Insurance contracts
- Share-based payment
- Technical plan

The IASB also held a joint meeting with the US Financial Accounting Standards Board (FASB) on 20 and 21 October, when the boards discussed:

- Credit crisis
- Conceptual framework
- Consolidation
- Derecognition
- Emissions trading
- Fair value measurement
- Financial instruments: reducing complexity
- Financial instruments with characteristics of equity
- Liabilities: uncertainties and expected cash flows

Credit Crisis

The Board discussed various aspects of its response to the credit crisis:

- Amendments to IAS 39
- Consolidation
- Derecognition of financial instruments
- Inactive markets

Amendments to IAS 39

In response to requests to address differences between the reclassification requirements of IAS 39 *Financial Instruments: Recognition and Measurement* and US GAAP, the Board approved amendments to IAS 39. The amendments allow an entity to reclassify some:

- non-derivative financial assets out of the held-for-trading category in rare circumstances
- loans and receivables out of the held-for-trading or available-for-sale categories if the entity has the intention and ability to hold the asset for the foreseeable future or until maturity.

The amendments also amend IFRS 7 *Financial Instruments: Disclosures* to require extensive disclosures for any financial asset reclassified in the situations described.

The Board normally publishes an exposure draft of any proposed amendments to IFRSs to invite comments from interested parties. However, given the requests to address this question urgently in the light of market conditions, and after consultation with the Trustees of the IASC Foundation, the Board decided to issue the amendments immediately.

After the amendments had been issued on 13 October, in response to requests for clarification, the Board made clear that any reclassification made on or after 1 November 2008 takes effect from the date of reclassification. However, any reclassification before 1 November 2008 can take effect from 1 July 2008 or a subsequent date. The Board also emphasised that a reclassification cannot be applied retrospectively before 1 July 2008.

Consolidation

The Board continued its discussion of a staff draft of an exposure draft for consolidation. The discussion related mainly to structured entities, benefits and the effects of holding options or convertible instruments when determining who has power to direct the activities of an entity. The next version of the draft will incorporate the Board's comments and revisions.

The Board also held an education session on the proposed amendments to FASB Interpretation 46(R*) Consolidation of Variable Interest Entities*, published by the FASB in September 2008 for public comment. The materials are in the observer notes for this meeting at: http://www.iasb.org/Meetings/IASB+Board+Meeting+16+October+2008.htm. No decisions were made.

Derecognition of financial instruments

In June 2008 the Board added derecognition of financial instruments to its active agenda. At this meeting, the Board discussed two possible approaches to derecognition of financial assets. The IASB and the FASB discussed this topic further at their meeting on 20 and 21 October. No decisions were made.

Inactive markets

The staff reported on the activities of the Expert Advisory Panel. The IASB established this Panel in May 2008, at the request of the Financial Stability Forum, to consider the application of fair value when markets become inactive.

The Panel had met seven times, most recently on 10 October. At that meeting, the Panel emphasised that the objective of a fair value measurement is the price at which an orderly transaction would take place between market participants on the measurement date, not the price that would be achieved in a forced liquidation or distress sale.

Tel: +44 (0)20 7332 2730
Fax: +44 (0)20 7332 2749
Website: www.iasb.org
Email: publications@iasb.org
ISSN 1474-2675

The Panel reaffirmed that a fair value measurement does not consider a forced liquidation or distress sale, whilst noting that even in times of market dislocation not all market activity arises from forced liquidations or distress sales.

The Panel also emphasised existing guidance within IFRSs that using the entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.

The Panel also reviewed feedback received from interested parties on a draft document summarising the Panel's discussions and started the process for completing its guidance. The Board posted the draft document on its Website on 16 September. The final document will be posted on the IASB Website and included in the updated edition of the education guide to the financial instruments standards.

Next steps

The Board will continue its discussions on consolidation and derecognition in November. To learn more about the Board's response to the credit crisis, please refer to the credit crisis page on the Website http://www.iasb.org/About+Us/About+the+IASB/Response+to+the+credit+crisis.htm.

Annual improvements

As part of its annual improvements project, the Board discussed two issues in IAS 39 *Financial Instruments: Recognition and Measurement.* The issues relate to the definition of a derivative and the effective interest method.

Definition of a derivative

The Board considered comments received on the amended definition of a derivative proposed in the exposure draft *Improvements to International Financial Reporting Standards*, published in 2007. The definition in IAS 39 excludes contracts linked to non-financial variables that are specific to a party to the contract. The exposure draft proposed to delete this exclusion.

The Board tentatively decided not to proceed with the proposed amendment in the annual improvements project but will consider addressing this issue in a future project.

Effective interest method

Earlier this year, the IFRIC received a request for guidance on the application of the effective interest method to a financial instrument with future cash flows linked to changes in an inflation index. The IFRIC did not add the issue to its agenda but recommended that the Board should consider clarifying or expanding the relevant guidance in IAS 39.

At this meeting, the Board decided tentatively as follows:

- For the effective interest method, a *floating rate financial instrument* is an instrument with contractual variable cash flow amounts arising from changes in market variables. The Board will not define the term *market variable* but may provide examples.
- Expectations (and changes in expectations) of future cash flows are not considered when calculating the effective interest rate for floating rate instruments.

The Board asked the staff to prepare a draft of the proposed amendments.

Fair value measurement

In June 2008 the Board reaffirmed its preliminary view as articulated in the discussion paper *Fair Value Measurements* that a fair value measurement should be determined using the price within the bid-ask spread that is most representative of fair value in the circumstances.

At this meeting, the Board tentatively decided:

- not to preclude the use of mid-market pricing or another pricing convention as a practical expedient for a fair value measurement within a bid-ask spread.
- to specify that the bid-ask spread guidance applies in all levels of the fair value hierarchy.
- not to include guidance on offsetting positions. This is because the bid-ask pricing guidance allows entities to determine, for each position, the price within the bid-ask spread that is most representative of fair value in the circumstances.

Financial instruments with characteristics of equity

The Board published the discussion paper *Financial Instruments with Characteristics of Equity* in February 2008. The comment period ended in September. At this meeting the Board considered an analysis of the comment letters received.

The Board also discussed which approach for identifying equity instruments provides the best starting point for future deliberations. No decisions were made. The IASB and the FASB discussed this topic further at their meeting on 20 and 21 October.

IFRS for private entities (formerly small and medium-sized entities, or SMEs)

At this meeting the Board discussed issues that had been deferred at previous meetings and made the following tentative decisions:

Consolidation - temporary control. In the light of the Board's decision at its meeting in September 2008 to eliminate the 'held for sale' classification, the Board considered whether there should be an exemption from consolidation for a subsidiary that was acquired with an intention to dispose of it in the near future. In effect, such an exemption exists under full IFRSs. The Board decided that a similar exemption from consolidation should be added for subsidiaries where on acquisition there is evidence that control is intended to be temporary (ie there is an intention to dispose of the subsidiary within twelve months and management is actively seeking a buyer). If the condition for exemption is met, the investor would need to provide specified disclosure.

Options as hedging instruments. Purchased options should not be permitted as hedging instruments under the hedge accounting provisions of Section 11. This decision would not prevent private entities from using purchased options to hedge risks or from disclosing the effect of doing so; it would only prohibit hedge accounting for those transactions.

Operating leases. The staff presented a revised proposal to modify the application of the straight-line method by lessees for operating leases if minimum lease payments are structured to compensate the lessor for expected inflation. The Board supported the staff proposal but clarified that 'expected inflation' means changes in general purchasing power based on published statistics, rather than a general estimate of the lessor's future cost increases.

Classification of equity/liability. The Board decided to incorporate into the IFRS for Private Entities the amendment to IAS 32 *Financial Instruments: Presentation* issued in February 2008 on puttable instruments and obligations arising on liquidation. The Board rejected a staff proposal to reword the amendment.

Definition of government grant. The staff withdrew a recommendation that would have removed from the definition of a government grant the phrase 'in return for past or future compliance with certain conditions relating to the operating activities of the entity'.

Remaining issues. The Board will discuss the remaining issues in November and December. Some of the main issues outstanding relate to restructuring the financial instruments section, possible replacement of the term 'fair value', concepts and pervasive principles, equity-settled share-based payments, defined benefit plans, income taxes, and impairment of goodwill. The staff will also ask the Board to revisit some of the tentative decisions made during its redeliberations, including the name of the standard, consolidation, amortisation of indefinite-life intangibles, and recognition of actuarial gains and losses.

Insurance contracts

The Board discussed measurement approaches that are possible candidates to be applied to insurance liabilities. The session was educational and no decisions were made.

The Insurance Working Group will discuss the candidate measurement approaches at a public meeting on 10 and 11 November in London. People wishing to observe the meeting may register through the Website at www.iasb.org/meetings. The Board will reach a tentative conclusion on the measurement approach at a subsequent meeting.

Share-based payment

The exposure draft (ED) *Group Cash-settled Share-based Payment Transactions* addressed how an entity that receives goods and services from its suppliers should account in its separate financial statements for share-based payment arrangements that are settled in cash by a group entity on its behalf. This was the Board's first discussion of the project since the publication of the ED in December 2007.

The staff presented a summary of the comment analysis and of the IFRIC's discussions in May and July. The Board tentatively confirmed the proposal in the ED to include all forms of group share-based payments in the scope of IFRS 2 *Share-based Payment*. However, to achieve this objective the Board also tentatively decided to amend some of the defined terms in IFRS 2 rather than amend IFRIC 11 IFRS 2—*Group and Treasury Share Transactions*.

The Board will consider the measurement of these arrangements at a future meeting.

Technical plan

The Board made its regular review of its Technical Plan. The Plan sets out the expected timetable over the next three years for projects on the IASB's active agenda and research agenda. The revised timetable will be available shortly at: http://www.iasb.org/Current+Projects/IASB+Projects/IASB+Work+Plan.htm. Project summaries are available on the IASB Website at: http://www.iasb.org/Current+Projects.

Joint meeting – IASB and FASB

The IASB held a meeting with the FASB on 20 and 21 October and discussed:

- Credit crisis
- Conceptual framework
- Consolidation
- Derecognition
- Emissions trading
- Fair value measurement
- Financial instruments: reducing complexity
- Financial instruments with characteristics of equity
- Liabilities: uncertainties and expected cash flows

Credit crisis

The boards decided to create a global advisory group comprising regulators, preparers, auditors, investors and other users of financial statements. The advisory group will help to ensure that reporting issues arising from the global economic crisis are considered in an internationally co-ordinated manner.

Advisory group

The advisory group will comprise senior leaders with broad international experience with financial markets. The boards will task this high level advisory group with considering how improvements in financial reporting could help enhance investor confidence in financial markets. The group will also be charged with identifying the accounting issues requiring urgent and immediate attention of the boards as well as issues for longer-term consideration. The high level advisory group will also draw upon work already under way in a number of jurisdictions on accounting and the credit crisis.

The boards will seek to identify external chairs and members of the group as soon as possible to enable the advisory group to begin its work expeditiously.

In developing their approaches on issues resulting from the discussions the boards will follow appropriate due process. In the interest of transparency, the advisory group will meet in public session with Webcasting facilities available to all interested parties.

Public round tables

In the coming weeks, while the advisory group is being established, the boards will organise three round tables - one each in Asia, Europe and North America. The purpose of these public round tables is to gather input on reporting issues arising from the current global financial crisis - including responses by governments, regulators and others. This should enable the boards to act rapidly and the advisory group, once established, to advance its deliberations efficiently.

Common long-term solutions

In addition to considering the potential for short-term responses to the credit crisis, both boards emphasised their commitment to developing common solutions aimed at providing greater transparency and reduced complexity in the accounting of financial instruments. The boards will use their joint discussion paper *Reducing Complexity in Reporting Financial Instruments*, the responses received to that paper, and the deliberations of the high level advisory group as starting points for this longer term objective. The boards will reconsider the composition of the existing IASB Financial Instruments Working Group to ensure that the working group provides appropriate and balanced advice to both boards.

Conceptual framework

The boards tentatively adopted the working definitions of an asset and of a liability for Phase B (recognition and measurement) of their joint project on the conceptual framework prepared by the staff. Please refer to the observer note on the IASB Website at http://www.iasb.org/NR/rdonlyres/48828CBF-941B-4E69-A64E-529A4E38C760/0/CF0810jointb02obs.pdf

Next step

The boards will consider at future meetings how the working definition of a liability interacts with the boards' joint project on financial instruments with characteristics of equity.

Consolidation

The boards considered the feasibility of developing common standards on consolidation by discussing the similarities and differences in the FASB's recently published exposure draft proposing amendments to FASB Interpretation No. 46(R) and the IASB staff's draft of an exposure draft on consolidation, to be published before the end of the year. The boards' discussions related mainly to the scope of the exposure drafts, the definition of control and disclosure.

The boards agreed that the likely timing of any final standards, and responses on the feasibility of the proposals, are important determinants of a convergence strategy. The boards therefore agreed that a decision on any such strategy should be made after the IASB has published its proposals and the FASB has received comments on its proposals.

Derecognition

The boards discussed the following proposed derecognition principle for financial assets:

"An entity should derecognise a financial asset or component thereof when it no longer qualifies as an asset of the entity (ie when the economic benefits no longer exist or the economic benefits exist but the entity ceases to have the ability to (a) obtain the future economic benefits inherent in the asset/component and (b) restrict others' access to those benefits)."

The boards also discussed two possible approaches to making that principle operational:

- Approach 1 – A transferor of a financial asset (or a component thereof) should derecognise the financial asset (or component) if:
  - (a) the transferor has no continuing involvement in the asset transferred,
  - (b) the transferee:
    - i. has the practical ability to transfer the asset transferred to a third party for its own benefit, and
    - ii. is able to exercise that practical ability unilaterally and without needing to impose additional restrictions on the transfer or
  - (c) the transferee presently has other access to the economic benefits underlying the transferred asset for its own benefit.
- Approach 2 – excludes criterion (c) above, restricts what items could qualify as part or a component of an asset, and requires linked presentation if specified conditions are met.

A majority of each board expressed a preliminary preference for Approach 2, but asked the staff to develop both approaches further. The boards did not make any decisions.

Emissions trading schemes

The boards discussed accounting for emissions trading schemes, including how to account for:

- the receipt of allowances in a cap and trade scheme
- the baseline in a baseline and credit scheme

The session was educational and no decisions were made.

Fair value measurement

The boards received an update on:

- the IASB's project on fair value measurement
- the work of the IASB's Expert Advisory Panel on the measurement and disclosure of fair value when markets are no longer active.

The session was educational and no decisions were made.

Financial instruments: reducing complexity

The boards discussed comment letters received in response to the IASB's discussion paper *Reducing Complexity in Reporting Financial Instruments* and the FASB's exposure draft *Accounting for Hedging Activities: an amendment of FASB Statement No. 133*. The boards discussed how to move forward with the projects on a joint basis.

The session was educational and no decisions were made.

Financial instruments with characteristics of equity

The boards decided to begin future deliberations using the principles underlying the perpetual and basic ownership approaches. Under the perpetual approach, an instrument would be classified as equity if it:

- lacks a settlement requirement and
- entitles the holder to a share of the entity's net assets in liquidation.

Under the basic ownership approach, an instrument would be classified as equity if it:

- is the most subordinated claim and
- entitles the holder to a share of the entity's net assets.

The boards acknowledged that they may decide to make exceptions to the basic principles as they continue to develop an approach to identify equity instruments.

Liabilities: uncertainties, and expected cash flows

The boards discussed the role of expected cash flows in recognition and measurement decisions. They decided tentatively that:

- expected outcome approaches do not play a role in recognition decisions. They are a measurement tool to be used after the decisions about recognition.
- decisions on measurement should be independent of decisions about recognition.
- in principle, measurements under conditions of uncertainty should take account of the range of possible outcomes and their relative probabilities (as in an expected outcomes approach). However, practical considerations may sometimes make it difficult to apply this principle. In general, IASB members stressed the benefits of the principle and FASB members stressed the practical concerns.

Future Board meetings

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

2008

17—21 November

15—19 December

