BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

June 2004

The International Accounting Standards Board met in Oslo, Norway on 21-23 June 2004, when it discussed:

- Business combinations (phase II)
- Consolidation
- Exploration for and evaluation of mineral resources
- Financial instruments
- Income taxes
- Leases
- Liabilities and equity
- Revenue recognition
- Small and medium-sized entities

In addition, the IASB met the Standards Advisory Council on 24 and 25 June 2004. A report of this meeting will be included in a forthcoming issue of *IASB Insight*.

Business combinations

Sweep issues for the Exposure Draft of amendments to IFRS 3 *Business Combinations*

The Board considered a number of issues that were identified during the drafting of an Exposure Draft of Amendments to IFRS 3 *Business Combinations* and Board members' review of that draft. The Board also considered issues that the FASB has considered as part of the project.

Transitional provisions for adjustments to consideration that are contingent on future events and for the subsequent recognition of acquired deferred tax assets

IFRS 3 provides that adjustments relating to the initial accounting for a business combination that arise after that accounting is complete should be recognised as a correction of an error, except for:

(a) adjustments to the cost of the combination that are contingent on future events.

(b) adjustments to the carrying amount of goodwill for the subsequent recognition of deferred tax benefits.

The Board considered whether, *after* the effective date of the revised IFRS 3, entities should be required to continue applying the requirements in the current version of IFRS 3 when dealing with a business combination:

(a) that was effected *before* the effective date of the revised IFRS 3; and

(b) for which deferred tax assets acquired as part of the combination or adjustments to the cost of the combination that are contingent on future events are recognised *after* the effective date of the revised IFRS 3.

The Board tentatively decided that entities should continue to apply the requirements in the current version of IFRS 3 when dealing with adjustments to the cost of a combination that are contingent on future events if the business combinations was effected *before* the effective date of the revised IFRS 3.

However, the Board tentatively decided that entities should no longer adjust the accounting for such business combinations for the subsequent recognition of acquired deferred tax assets, unless a rebuttable presumption applies. This presumption is that if the acquired deferred tax asset is realised within twelve months of the acquisition date, the subsequent recognition of the acquired benefits should be regarded as relating to conditions that existed at the acquisition date, and should therefore be accounted for as an adjustment to complete the initial accounting for the business combination. Because income taxes are excluded from the scope of this project, the Board agreed that the transitional provisions for the subsequent recognition of deferred tax assets should not be used as a transitional model for other adjustments arising from a business combination.

Transitional provisions for 'stand-alone' contingent liabilities

The Board considered how, *after* the effective date of the revised IFRS 3, an entity should account for 'stand-alone' contingent liabilities (ie contingent liabilities that are not accompanied by associated unconditional obligations) that still appear in the entity's balance sheet but arose from a business combination effected *before* the effective date of the revised IFRS 3. In particular, the Board considered whether the requirements currently in IFRS 3 should continue to be applied to these stand-alone contingent liabilities.

The Board tentatively decided that after the effective date of the revised IFRS 3 entities should retrospectively derecognise stand-alone contingent liabilities arising from business combinations effected before the effective date of the revised IFRS 3. Therefore, goodwill or any gain recognised in a prior period relating to a bargain purchase shall be adjusted retrospectively by an amount equal to the fair value at the acquisition date of the standalone contingent liabilities. Any subsequent changes in the measurement of the contingent liability should be derecognised against the opening balance of retained earnings.

Mutual entities

In June 2004, the Board considered whether the IASB's Exposure Draft should propose that business combinations involving two or more mutual entities or business combinations in which separate entities are brought together by contract alone should be accounted for in accordance with the Board's tentative decision in this project, rather than in accordance with the interim approach set out in the Exposure

(Continued…)

Copyright © IASB Update is published immediately after every IASB meeting by the International Accounting Standards Board,
30 Cannon Street,
London EC4M 6XH, United Kingdom
Email: iasb@iasb.org
Website: www.iasb.org

IASB Publications Department,
30 Cannon Street, London, EC4M 6XH
United Kingdom
Tel: +44 (0)20 7332 2730
Fax: +44 (0)20 7332 2749
Email: publications@iasb.org
ISSN 1474-2675

Draft of Proposed Amendments to IFRS 3 *Combinations by Contract Alone or Involving Mutual Entities* (the *Mutuals ED*).

In its Mutuals ED, the Board noted that one of the difficulties in applying the acquisition method to combinations of mutual entities or in which separate entities are brought together solely by contract is that such transactions normally do not involve the payment of any reliably measurable consideration. Therefore, the Board concluded that difficulties arise in estimating the cost of the business combination and any goodwill acquired in the combination. However, the Board had previously reached a tentative decision in this project that the acquisition method can and should be applied in accounting for business combinations that do not involve the payment of reliably measurable consideration.

The Board tentatively decided that the Exposure Draft should propose that such business combinations should be accounted for in accordance with the proposals in the Phase II project. The Board noted that its decisions in this project had addressed the difficulties noted in the Mutuals ED. In addition, the Board agreed to consider, before publishing its Exposure Draft, the issues that the FASB considered in respect of mutual entities to the extent that those issues have not already been dealt with by the IASB. For example, the Board will consider the accounting for the 'other side' of the business combination transaction (surplus or deficit) in the acquirer's financial statements. The Board also agreed to explore whether there might be issues unique to combinations in which separate entities are brought together by contract alone that justify an accounting treatment different from that provided in this project for other combinations.

Whether to amend the fair value hierarchy

In this project, the FASB and IASB have agreed to use fair value as the measurement objective for the business acquired in a business combination. The boards developed guidance for measuring fair value (the *fair value hierarchy*) to ensure consistent application of the fair value measurement requirement.

Subsequently, the FASB agreed to amend the fair value hierarchy to reflect decisions made by it as part of its Fair Value Measurements project and include that revised hierarchy in its Phase II Exposure Draft. Given that the boards had decided previously that their Exposure Drafts should, to the extent possible, use identical style and wording, the IASB considered whether to amend the fair value hierarchy to incorporate the changes agreed by the FASB.

The Board agreed that in the interests of convergence its objective should be to expose the same fair value hierarchy as the FASB and the Board will consider the issues that resulted in the changes to the hierarchy made by the FASB at a future meeting.

The Board tentatively decided that the fair value hierarchy should be exposed as a separate Exposure Draft and would draw constituents' attention to the implications of introducing it into IFRSs. This hierarchy would apply in IFRSs generally, but only to the extent that an existing IFRS requires an asset or liability to be measured at fair value. The Hierarchy Exposure Draft would not propose to extend the use of fair value measurement. The Business Combinations Exposure Draft should merely refer to the Hierarchy Exposure Draft.

Guidance on using a market approach and an income approach to measuring fair value

The FASB is planning to include in its Phase II Exposure Draft application guidance on measuring the fair value of the business acquired when the fair value of the consideration exchanged does not provide the best basis for measuring the fair value of the business acquired and, therefore, that fair value should be estimated using valuation techniques (such as a market approach and an income approach).

The Board tentatively decided that its Exposure Draft should also include guidance on using valuation techniques (such as a market approach and an income approach) when measuring the fair value of the business acquired.

Reducing goodwill for the amount of a bargain purchase

The Board tentatively decided to clarify in its Exposure Draft that in a business combination that is not an exchange of equal values, any excess of the fair value of the acquirer's interest in the *business acquired* over the fair value of the consideration given for that interest should be recognised as a reduction in the total amount of *goodwill* (including goodwill attributable to minority interests) until the goodwill is reduced to zero; and any excess remaining after the *total* amount of goodwill has been reduced to zero should be recognised immediately in profit or loss. This is consistent with the Board's decision to not recognise goodwill and a bargain purchase at the same time. However, the Board agreed to highlight in its Exposure Draft that this decision represents an exception to the fair value working principle.

Replacement of acquiree share-based payment awards

The Board discussed various issues considered recently by the FASB relating to the accounting treatment of share-based payment awards of the acquiree that are replaced by the acquirer in a business combination. The Board tentatively decided that:

- A replacement share-based payment award should be regarded as relating to a business combination if the acquirer had an obligation to replace the acquiree's award.
- The fair value guidance in IFRS 2 *Share-based Payment* should be applied when measuring the fair value of the acquiree award and the fair value of the replacement acquirer award at the acquisition date.
- If, at the acquisition date, the fair value of the replacement acquirer award exceeds the fair value of the acquiree award, that incremental fair value should be accounted for as post-combination compensation expense of the acquirer.
- The remaining fair value of the acquirer replacement award (ie the total fair value of that award less any incremental fair value) should be allocated between the purchase price and post-combination compensation expense. The Board made tentative decisions that would achieve convergence with those of the FASB, except that it agreed to ask the FASB to reconsider allocation issues related to the replacement of a vested award with an award with a future service requirement. The Board will discuss this issue again at a future meeting.
- Having determined the amount to include in the purchase price, no subsequent adjustments should be made to the purchase price. Hence, the effects of subsequent events should be accounted for in the post-combination period.

 Copyright © 2004 International Accounting Standards Committee Foundation

Consolidation

The Board continued its discussion of how the control definition[1] should be applied to fiduciaries with the ability to exercise power over the financial and operating policies of an entity (the 'power criterion'). In May 2004, the Board tentatively decided that an entity acting solely as a fiduciary should not meet the control definition. This is because of the restrictions placed on the use of any power held by a fiduciary because of its fiduciary obligations. However, to ensure that restricting application of the control definition based on the presence of fiduciary obligations is appropriate, the Board asked the staff to investigate further the nature of fiduciaries.

The staff noted that the circumstances in which fiduciary obligations arise vary by jurisdiction. The staff also noted that entities, in addition to those traditionally described as fiduciaries (such as trustees), may have fiduciary obligations in certain circumstances. For example, a controlling shareholder may owe fiduciary duties to non-controlling shareholders when proposing transactions that will disproportionately benefit the controlling shareholder. The Board has previously decided that an entity need not have unlimited power in order to meet the control test. Accordingly, the presence of fiduciary obligations that give rise only to protective rights[2] should not detract from the notion of control. In view of the wide range of circumstances in which fiduciary duties arise, the staff concluded that a general presumption that the control test would not be met whenever fiduciary duties exist was not appropriate.

The Board tentatively decided that the staff should focus on clarifying how the control test should operate by specifying those aspects of a fiduciary relationship that differentiate the particular circumstances of a fiduciary from those of a controller. In particular, the Board tentatively decided that the staff should pursue further an approach whereby an entity should fail the control test only when the effect of its obligations is that:

- It has power but is explicitly required by agreement or at law to use that power for the benefit of third parties. In these circumstances the entity is prevented from acting in its own interests to the detriment of the third parties
- The entity's ability to benefit from the assets over which power is held is restricted. In particular, it is not able to deal with the assets as if they were its own and its entitlement to benefits must be agreed between itself and the third parties in whose benefit it must act (or entities representing those interests)
- Its benefits from the assets over which it has power are in effect limited to a fee for services provided.

The Board noted that the appropriateness of these criteria should be reassessed when the Board determines its approach to SPEs.

The Board then discussed how power and control should be assessed when an entity does not act solely as fiduciary. The Board's discussion focused on how control should be assessed when a fund manager has a dual role in relation to an investee (as both fiduciary and direct investor). The staff proposed three alternatives for how control should be assessed when a fund manager has a dual role[3]. In doing so, the staff was, in part, responding to concerns about abuse. The alternatives discussed were:

- *Alternative 1:* always to require a fund manager to assess its power in aggregate when it has a dual role as manager with power over a fund that holds an investment in an investee and as principal investor in relation to that same investee.
- *Alternative 2:* to adopt a rebuttable presumption that the fund manager should assess its power in aggregate when it has a dual role.
- *Alternative 3:* to allow a fund manager to assess its power and control excluding its influence arising as fiduciary, but require disclosure of supplementary information about the investee.

The Board tentatively decided that the staff should pursue Alternative 2 and develop suggested criteria for the rebuttable presumption for the Board's consideration. As initial suggestions the Board proposed that evidence of different decision-making processes for the fund's holdings and direct investments, the number of investors in the fund and the number of investments held by the fund manager may be relevant factors for consideration. The Board noted that if suitable criteria for the rebuttable presumption could not be developed, Alternative 1 would be preferable to Alternative 3.

Exploration for and evaluation of mineral resources

The Board began its redeliberation of ED 6 *Exploration for and Evaluation of Mineral Resources*, which it published for public comment in January 2004. The comment period for the Exposure Draft closed on 16 April 2004 and 54 comment letters were received. These comment letters are available on the Board's Website, *www.iasb.org.*

Definitions and additional guidance

The Board decided not to change the definitions of *exploration and evaluation assets*, *exploration and evaluation expenditures* and *exploration of and evaluation for mineral resources*. Additional guidance on the application of these definitions will be included in the IFRS to clarify their meaning. The Board clarified that exploration and evaluation expenditures do not include 'pre-exploration expenditures' and that such expenditures would be subject to the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, and would normally be recognised as an expense.

The Board decided to delete ED 6 paragraph 8(b), which stated that general and administrative expenses were excluded from the definition of exploration and evaluation assets.

The Board also decided not to provide additional guidance on expenditures to be included in and excluded from the definition of exploration and evaluation assets. Rather, users will be directed to use the existing guidance in IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

Method of accounting for exploration for and evaluation of mineral resources

The Board affirmed that an entity need not apply paragraphs 11 and 12 of IAS 8 when developing its accounting policies for exploration and evaluation expenditures. The Board also decided that IAS 8 paragraph 10 does apply to such policies.

[1] An entity has control if it meets the following criteria:
- The ability to determine strategic operating and financing policy (the power criterion);
- The ability to benefit (the benefit criterion); and
- The ability to use its power to protect, maintain or increase the level of those benefits.

[2] Protective rights (such as an obligation not to defraud minority shareholders) do not detract from a controller's ability to determine strategic operating and financing policy.

[3] Consistent with the tentatively agreed treatment of fiduciaries, outlined above.

Copyright © 2004 International Accounting Standards Committee Foundation

The Board decided not to specify whether exploration and evaluation assets should be classified as tangible or intangible assets. An entity should classify such assets according to their nature and adopt that classification consistently.

The Board affirmed that entities should be permitted to remeasure an exploration and evaluation asset when the criteria for revaluation are met. An entity should use the remeasurement model in either IAS 16 or IAS 38 consistently with how it classifies its exploration and evaluation assets.

The Board affirmed the principle that accounting changes should be assessed in accordance with IAS 8, but decided to conform the wording in the IFRS to that in IFRS 4 *Insurance Contracts*.

The Board decided to clarify that IFRS 3 *Business Combinations* applies to acquired exploration and evaluation assets.

Impairment of exploration and evaluation assets

The Board affirmed that an entity recognising an exploration and evaluation asset should be required to test that asset for impairment. However, the Board decided to modify the approach to the impairment test.

ED 6 proposed that entities should be required to test exploration and evaluation assets for impairment annually using the impairment test in IAS 36 *Impairment of Assets*. Constituents commented that many entities, especially those whose primary activity was exploration, would not be in a position to make a reasonable estimate of mineral reserves and cash flows. Applying the IAS 36 impairment test in such circumstances would almost certainly result in significant impairment of exploration and evaluation assets.

The Board decided to retain the impairment test in IAS 36, but to require its application only in circumstances in which entities are likely to have the necessary information. The Board identified a number of such circumstances and directed the staff to develop these principles further and present the modified approach to impairment at a subsequent meeting.

One of the most important aspects of testing for impairment is associating the relevant asset with future cash flows. The intention of the Board when it considered the impairment test in ED 6 was that entities should be able to test impairment by aggregating the exploration and evaluation asset with productive assets in the same segment. Respondents to ED 6 did not think that the Board had achieved its intention in this respect and many preferred to apply IAS 36 without the special ‘cash-generating unit for exploration and evaluation assets’. The Board will consider the special cash-generating unit further at its next meeting.

The Board decided that the IFRS should contain an expanded discussion of the impairment test, including the level at which impairment should be assessed.

Disclosure

The Board decided to state explicitly that an entity reporting exploration and evaluation assets should make the disclosures required by IAS 16 or by IAS 38, depending on how the entity classifies its exploration and evaluation assets.

The Board did not support requiring additional disclosures related to the extent of commercial reserves quantities, as this was beyond the limited scope of this project. For the same reason, the Board did not accept a suggestion that entities should disclose information on phases after exploration and evaluation. However, the Board asked the staff to consider whether guidance could be incorporated in the IFRS that encourages, for subsequent phases in an extractive activity, disclosures similar to those required for exploration and evaluation.

Project plan

The Board approved a plan for the remainder of this project. The plan envisages that the Board will complete its redeliberations in July and review a pre-ballot draft of an IFRS during August 2004. Any issues the Board identifies as a result of that review will be discussed at its September meeting. The IFRS would be issued some time in the fourth quarter of 2004.

Next steps

At its meeting in July 2004, the Board will consider the modified approach to impairment, issues related to transition, effective date and any other issues identified by respondents.

Financial instruments

Financial instruments puttable at fair value

The Board discussed the classification as liabilities or as equity of shares puttable at a pro rata share of the fair value of the residual interest in the issuer (referred to as shares puttable at fair value), including certain types of partnership capital. The Board noted that guidance for instruments that are not puttable at fair value was being developed by the IFRIC in its draft Interpretation D8 *Members’ Shares in Co-operative Entities* (due for release on 30 June 2004).

The Board decided that IAS 32 requires all instruments that are puttable for cash or other assets to be classified as liabilities. It noted that for shares puttable at fair value, the application of IAS 32 may result in apparently anomalous accounting. This is particularly true when the fair value of the entity differs significantly from its recognised net asst value. The Board therefore considered whether it should change IAS 32 to exempt shares puttable at fair value from the principle that instruments containing an obligation for the issuer to transfer cash or other assets are liabilities. Some Board members were concerned both about making any exception to the principles in IAS 32 and that such an exception might have unforeseen consequences.

The Board noted that this issue would be considered in its longer term project on liabilities and equity. In the short term, the Board instructed the staff to consider further whether it should propose an amendment to IAS 32 and, in particular, to explore the following three possible approaches:

- an exception so that instruments puttable at fair value are classified as equity
- continuing to classify such instruments as liabilities, but amending their measurement so that changes in their fair value would not be recognised
- consider whether all puttable instruments (and not only those puttable at fair value) should instead be separated into a put option and a host instrument.

In addition, the Board asked the staff to consider the effect of these possible approaches on other Board projects.

Financial instruments: Disclosures—Sweep issue

Paragraph 94(d) of IAS 32 requires entities to disclose the existence of multiple embedded derivative features in compound financial instruments whose values are interdependent, and the effective interest rate on the liability component.

As a result of the staff’s evaluation of the disclosure requirements in the proposed Exposure Draft 7 *Financial Instruments: Disclosures* undertaken since the May 2004 Board meeting, the Board tentatively decided to propose to delete the requirement for entities to disclose the effective interest rate on the liability component.

 Copyright © 2004 International Accounting Standards Committee Foundation

Income taxes

The Board discussed the differences between the application of the notion of 'tax base' in IAS 12 *Income Taxes* and the notion of 'tax basis' applied under US generally accepted accounting principles. The Board discussed the following primary differences:

- Amount deductible for tax purposes *vs* amount depreciable for tax purposes
- Tax base of items that have no tax consequences
- Effect of intent on determination of tax base

The Board decided that tax base is a function of the tax law for a specific jurisdiction and that management's intentions on how an asset will be recovered or a liability settled do not affect the determination of tax base. However, assuming there is a temporary difference, management's intentions may affect the measurement of a deferred tax asset or liability. For example, an entity looks to management's intentions if the rate at which the tax consequences will be measured may be dependent on the manner of recovery or settlement (eg ordinary income rate *vs* capital gains rate).

It was noted that the differences in the application of the notion of tax base are further complicated by differences in the definitions of temporary differences in IAS 12 and SFAS 109 *Accounting for Income Taxes*. The Board decided that the definition of a temporary difference in IAS 12 should be modified. Currently, IAS 12 defines temporary differences as "differences between the carrying amount of an asset or liability in the balance sheet and its tax base". The definition also states that temporary differences are either taxable temporary differences or deductible temporary differences. Accordingly, under IAS 12 all differences between the tax base of an asset or liability and the amount reported in the financial statements are temporary differences.

This is not the case under the SFAS 109 definition. Under SFAS 109, a difference between the tax base of an asset or liability and the amount reported in the financial statements does not necessarily mean there is a temporary difference for which deferred tax should be recognised. Only if the basis difference will result in either taxable or deductible amounts when the reported amount of the asset or liability is recovered or settled is it a temporary difference.

The Board tentatively decided:

- to modify the definition of tax base in IAS 12 to explain that tax base is a measurement attribute and is the amount at which an asset, liability or equity instrument is recognised for tax purposes under existing tax law as a result of one or more past events. That asset, liability, or equity instrument may or may not be recognised for financial reporting.

  The Board acknowledged that the concept of assets, liabilities and equity instruments for tax purposes (ie a 'tax' balance sheet) might not be intuitive in many jurisdictions. The Board decided to include additional guidance to clarify that these are the amounts that would be recognised in a balance sheet created using tax law as the basis for accounting. With respect to the tax law, it is the tax law that would apply to the taxpayer given its elections, status etc under the various provisions of the law. For example, it is likely that a cash basis taxpayer and an accrual basis taxpayer will have different tax bases reflected in their 'tax' balance sheets.
- to modify the definition of a temporary difference in IAS 12. The Board tentatively decided to clarify that a temporary difference is a difference between the tax base of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts when the reported amount of the asset or liability is recovered or settled. Events recognised in financial statements that do not have tax consequences do not give rise to temporary differences.

As a result of these tentative decisions, the Board also decided:

- to eliminate the requirement in IAS 12 that the tax base of items that have no tax consequences associated with them (ie 'permanent differences') be deemed to be equal to the carrying amount.
- to eliminate the guidance in paragraph 52(b) of IAS 12 that management's intentions on how an entity will recover (settle) the carrying amount of an asset (liability) can affect the tax base of an asset or liability.
- to include examples of tax base in the Application Guidance of revised IAS 12.

Project update

The staff also apprised the Board on the status of the project. The three primary issues that the IASB still has to deliberate are:

- allocations to shareholders' equity ('backwards tracing')
- investments in subsidiaries, branches and associates, and interests in joint ventures
- disclosure.

Allocations to shareholders' equity ('backwards tracing')—Both IAS 12 and SFAS 109 require the tax effects of items credited or charged directly to equity during the current year also to be allocated directly to equity. However, IAS 12 and SFAS 109 differ with respect to the allocation of current year deferred taxes related to an item that was credited or charged directly to equity in a prior year. Current year deferred taxes related to items credited or charged directly to equity in a prior year may arise from either changes in assessments of recovery of deferred tax assets or changes in tax rates, laws, or other measurement attributes. IAS 12 requires the allocation of the current year deferred taxes directly to equity, while SFAS 109 requires allocation to current year income. The Board previously discussed the complexity of the requirement at the April 2003 meeting and directed the staff to work with the FASB to develop the analysis further. The IASB and FASB staffs have been working together to develop a joint paper for both boards to consider. It is expected that the FASB will discuss this issue in August and the IASB will discuss it at its September meeting.

Investments in subsidiaries, branches and associates, and interests in joint ventures—At the July 2003 meeting, the IASB tentatively decided that an entity should recognise the income tax consequences of *all* temporary differences arising in the consolidated financial statements. The Board tentatively 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 it was noted that there may be practical considerations with respect to foreign subsidiaries and joint ventures and directed the IASB staff to work with the FASB staff to analyse the practical difficulties of the requirement. It is expected that the FASB will discuss this issue in July and the IASB will discuss it at the September meeting.

Disclosure—As the majority of the differences in the disclosure requirements of IAS 12 and SFAS 109 arise from other differences in the requirements of the two Standards, the IASB and FASB staffs will prepare a joint paper on disclosure after the other differences have been deliberated.

Copyright © 2004 International Accounting Standards Committee Foundation

The staff also noted that the FASB will shortly begin deliberating issues previously considered by the IASB. It is expected that most of the issues will be considered before the joint meeting in October 2004. Those issues still to be deliberated by the FASB include:

- Scope - exceptions in applying the basic principles
  - Intercompany transfers of inventory or other assets remaining within the group
  - Foreign non-monetary assets that are remeasured from the local currency into the functional currency using historical exchange rates and result from (i) changes in exchange rates or (ii) indexing for tax purposes
- Measurement criteria for deferred tax assets and liabilities
  - 'Substantively enacted' rate *vs* Enacted rate
  - Undistributed rate *vs* Distributed rate
- Recognition criteria for deferred tax assets
  - 'Affirmative judgement approach' *vs* 'Impairment approach'

Leases

The Board's discussions of the leasing research project have focused on the assets and liabilities that might be recognised at the beginning of a lease under a model that is based on the analysis of contractual rights and obligations. At this meeting the Board considered a paper, prepared by the UK Accounting Standards Board, that considered how assets and liabilities recognised by lessees might change over the lease period and how those changes might be presented in an income statement. Among the changes that would be reflected are amortisation and impairment of assets, unwinding of the discount on liabilities and changes in estimates when lease payments are estimated. The examples discussed were of (i) a straightforward lease that gives rise to a right of use and a fixed payment obligation; (ii) a lease with payments that are conditional on external price changes; (iii) a lease with payments that are conditional on the lessee's usage; (iv) a lease with payments that are conditional on the lessee's revenues; (v) a lease with a renewal option.

The Board decided, as a general matter, that it was necessary to consider the appropriate measurement model after recognition (ie amortised cost or fair value) for the component rights and obligations that would be recognised as assets and liabilities. The Board suggested it would be useful to consider the measurement bases for assets and liabilities set out in the Board's existing standards, including the application of IAS 16 or IAS 38 to lease assets and IAS 37 or IAS 39 to lease liabilities.

The Board discussed alternative approaches in the cases of leases with lease payments conditional on the lessee's usage or revenues. One approach was to reflect the lessee's expected usage or revenues in the assets and liabilities arising from the lease. The Board decided that, under that approach, the remeasurement of a liability to reflect a change in estimated lease payments should not automatically be added to or deducted from the carrying amount of the related asset.

The Board decided that, in concept, a renewal option should be accounted for separately from a right of use, but noted that a standard would have to address difficulties in measuring the option at the beginning of the lease and subsequently during the lease.

Liabilities and equity

Reassessed expected outcomes approach

The Board discussed the 'reassessed expected outcomes' approach that is being explored by the FASB as a part of its Liabilities and Equities project. The discussion was informational and no decisions were made.

The reassessed expected outcomes approach would account for equity-linked financial instruments based on the modern financial theory that investors and others use to price options and contingent claims. The aim of the approach is to provide consistent classification, measurement and EPS treatment for economically similar transactions. It would distinguish liabilities and assets from equity based on expected future flows of cash and other economic resources, and remove incentives for 'accounting arbitrage' (details of the approach are available in the observer notes for this meeting on the IASB's Website).

The Board considered the various advantages and disadvantages of the approach. It noted that the approach, although providing interesting results, raises various issues that would have to be resolved for the approach to be applied. The Board tentatively decided to consider the approach further and thanked the FASB staff for their participation.

Revenue recognition

In May 2004, the Board tentatively decided that, in concept, at the measurement date the fair value of an entity's performance obligations to a customer is the price that would have to be paid to a third party of comparable credit standing to assume legal responsibility for performing all of the entity's remaining obligations (referred to as the 'legal layoff amount'). That price would be found in a business-to-business market.

At the May 2004 meeting, Board members had raised various issues regarding the application of that concept, including whether different prices for an obligation might exist in different business-to-business markets. In June 2004, the Board discussed an example of how to measure an entity's performance obligations at their legal layoff amount. The example illustrated that different prices do not indicate the existence of different markets. Rather, they are for different bundles of goods and services. Thus, there is only one legal layoff amount for a given set of performance obligations to a customer. Board members generally agreed with the analysis in the example.

The Board discussed the reliability threshold for estimates affecting revenue recognition. The Board tentatively decided that the reliability threshold for these estimates should be the same as for estimates affecting other elements of financial statements (including, in particular, estimates affecting expenses, gains and losses).

The Board considered several examples of direct and indirect measures of the fair value of performance obligations that might be obtained or developed in practice. The principal focus of those examples was to test whether those fair value measures would be sufficiently reliable to merit recognition in financial statements when the information available to support estimates of them was at level 3 of the proposed Fair Value Hierarchy used by the IASB and FASB in their joint project on business combinations. At that level, quoted prices for identical or similar performance obligations in active markets are unavailable. The discussion was exploratory in nature. Board members' comments will form the foundation for future development of draft guidance on the fair value of performance obligations.

 Copyright © 2004 International Accounting Standards Committee Foundation

Financial reporting standards for small and medium-sized entities

The staff noted that the IASB Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities* was published on 24 June 2004, with comments requested by 24 September 2004. To encourage responses from SMEs, the Board had mailed the Discussion Paper to over 40 representative organisations of SMEs globally, encouraging them and their members to engage with the Board on this project.

The staff had continued the process of extracting the concepts and principles from the *Framework for the Preparation and Presentation of Financial Statements* and IFRSs and converting them into first drafts of proposed IASB Standards for SMEs. In June 2004, the Board discussed extractions from IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Board's review of those drafts was preliminary and no decisions will they be made until after the comments on the Discussion Paper have been considered.

The Board considered a number of issues relating to the IAS 1 and IAS 8 extractions, as follows:

Accounting policy choices: The Board tentatively decided that, as a matter of general approach to developing IASB Standards for SMEs, all accounting policy choices allowed in IFRSs should also be available to an SME.

Mandatory fallback to an IFRS: The Board considered whether mandatory fallback to an IFRS should be on an issue-by-issue basis or on a standard-by-standard basis. The Board decided that the mandatory fallback to full IFRSs would be on an issue-by-issue basis.

Preface to IASB Standards for SMEs: The Board decided that there was a need for a preface, or similar document, for any SME series of standards it might produce. Such a document would explain which entities would be eligible to use the SME standards and the requirements relating to voluntary and mandatory fallbacks to full IFRSs.

Interpretations. The Board decided that if, for any reason, an SME was required to use an IFRS in accounting for a transaction, the SME would also be required to consider any related Interpretations of that IFRS. The Board also decided that when an Interpretation is relevant to SMEs that Interpretation should be incorporated into the relevant IASB Standard for SMEs.

Criteria for changes to an IFRS in an SME Standard. The Board decided that the principal criteria for justifying a change to an IFRS in developing the SME version should be:

- The issue is unlikely to arise in an SME. If it does arise, there is the mandatory fallback to IFRSs.
- Meeting user needs. This could involve additional or reduced disclosures, as necessary.
- Providing guidance in applying an IFRS principle to a type of transaction common to SMEs. This might involve including guidance that is not part of the IFRS, or developing additional material
- Simplifying a measurement calculation while still achieving compliance with the measurement principle in an IFRS.
- Assessing a presentation or disclosure requirement is deemed burdensome on the basis of a cost-benefit analysis.

The Board also decided that the basis for conclusions for each SME standard should explain the rationale for departures from full IFRSs.

Going concern. The Board decided that the requirement in IAS 1 for an entity that is not a going concern to disclose that fact should be retained in the SME version of the Standard. The Board also decided not to provide further guidance, in IAS 1-SME, on accounting for an entity that is not considered to be a going concern.

Current/non-current balance sheet presentation. IAS 1 permits a liquidity presentation of the balance sheet when the entity concludes that this presentation provides more relevant and reliable information than a current/non-current presentation. The Board discussed whether a requirement to assess relevance and reliability is burdensome for an SME. The Board decided that the IAS 1 approach should be retained in IAS 1-SME and that further guidance should be provided on making the assessment of relevance and reliability.

Analysis of expenses. The Board decided to permit expenses to be analysed either on the basis of the nature of expenses or their function within the entity.

Guidance in IFRSs. The Board decided that the illustrative examples and guidance in IAS 1 should be retained in IAS 1-SME with the same status as they have in IAS 1.

Statement of changes in equity: The Board decided that the format of the statement of changes in equity in IAS 1 that includes transactions with owners as owners was likely to be more relevant in an SME context and should be required in IAS 1-SME. However, that standard should indicate that an SME that wished to use the alternative format should look to the guidance in IAS 1.

Disclosure of judgements. IAS 1 requires disclosure of judgements made by management in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements. The Board decided not to retain this requirement in IAS 1-SME.

Disclosure of key assumptions: IAS 1 requires note disclosure of information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. The Board decided to require this disclosure in IAS 1-SME.

Fair presentation. The Board decided to include in IAS 1-SME a cross-reference to the requirements of IAS 1 paragraphs 13-22.

Meeting dates: 2004

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

20—22 July

22—24; 27§, 28‡ September

18—20 October, Norwalk, Connecticut, USA

15—19 November†

15—17 December

† Includes a meeting with the Standards Advisory Council

‡ Includes meetings with partner standard-setters

§ Includes meetings with other national standard-setters

Copyright © 2004 International Accounting Standards Committee Foundation