Project: **Annual Improvements – 2009–2011 cycle**

Topic: **Issues recommended by the Committee not to lead to amendments within the scope of the *Annual Improvements* process**

Introduction

1. At its meeting in March 2010, the IFRS Interpretations Committee (the Committee) reviewed a selection of issues for potential resolution through the *Annual Improvements* process for 2009-2011.

2. The Committee tentatively decided to recommend to the Board not to proceed with three of these issues through the *Annual Improvements* process.

3. This paper discusses collectively these three issues.

Purpose of this paper

4. The objective of this paper is to:

   (a) present background information for these issues,

   (b) give an overview of the analysis of the issues,

   (c) explain the rationale for the Committee's decision not to recommend that the Board amend the relevant standards through the *Annual Improvements,* and

   (d) ask for the Board agreement with the Committee's recommendation.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

IFRS 3 *Business Combinations* — Contingent consideration and first-time adoption

Background information

5. The *Improvements to IFRSs* published in May 2010 includes an amendment to IFRS 3 clarifying the transition relief for existing IFRS preparers for contingent consideration arising from a business combination that occurred before the effective date of the revised IFRS 3.

6. However, there is no equivalent relief for first-time adopters. The Committee requested that the staff consider whether similar relief should be provided to first-time adopters. The relief would be for contingent consideration balances from a business combination that occurred before the transition date to be accounted for in accordance with the requirements in IFRS 3 (issued 2004).

7. At the time it issued IFRS 3 (revised 2008), the Board deleted a paragraph in the Business Combinations exemption in IFRS 1 *First-time Adoption of International Financial Reporting Standards* relating to contingent consideration. This paragraph had permitted contingent consideration balances arising from business combinations accounted for under previous GAAP to be adjusted against goodwill at transition date.

8. This paragraph, that has been deleted from IFRS 1, is reproduced below:

> A contingency affecting the amount of the purchase consideration for a past business combination may have been resolved before the date of transition to IFRSs. If a reliable estimate of the contingent adjustment can be made and its payment is probable, the first-time adopter shall adjust the goodwill by that amount. Similarly, the first-time adopter shall adjust the carrying amount of goodwill if a previously recognised contingent adjustment can no longer be measured reliably or its payment is no longer probable.

9. As a result of the deletion of this paragraph the current requirement under IFRS 1 is that any outstanding contingent consideration balance at transition date is recognised at fair value. The adjustment required from previous

GAAP to this amount is recorded against opening retained earnings (or other appropriate component of equity). Post transition, changes in such balances are accounted for in accordance with paragraph 58 of IFRS 3 (revised 2008).

10. The issue was considered by the Committee because it was an additional issue raised in comment letters to the exposure draft on *Improvements to IFRSs* published in August 2009. The Committee discussed the issue as part of the comment letters analysis at its public meeting in March 2010.

Summary of the analysis on these issues

11. The following is a summary of the analysis discussed in March 2010. The full staff analysis was set out in agenda paper 7B that can be found on the public website[1].

Relief limited to situations where previous GAAPs were similar to IFRS 3 (issued 2004)

12. Some constituents have suggested an exemption could be limited to situations where previous GAAPs were similar to IFRS 3 (issued 2004) in that contingent consideration adjustments are required to be recorded against goodwill.

13. However, the staff noted that it would prove difficult to assess similarities. Assessing whether previous GAAPs are similar or not could be an arbitrary determination.

Extent of relief to be considered

At transition date – initial measurement

14. Some constituents had noted that existing preparers are currently required to recognise contingent consideration arising from business combinations that occurred before the date the entity first applied IFRS 3 (revised 2008) only if

[1] http://www.iasb.org/Meetings/IFRIC+Meeting+March+2010.htm

probable, in accordance with [future] paragraph 65B of IFRS 3 (revised 2008). This is a continuation of previous accounting policy.

15. However, the staff noted that allowing contingent consideration to be recognised at transition date (on first-time application) only when probable is inconsistent with current IFRS 3 (revised 2008) and with IFRS 1's principle of applying the same policies to the opening balance sheet and all periods presented.

At transition date – recognition of resulting adjustments: goodwill or retained earnings

16. Some constituents noted that recognising adjustments to contingent consideration at transition date against goodwill is consistent with how contingent consideration would have affected goodwill at the date of acquisition had it been initially recognised in accordance with IFRS 3 (revised 2008).

17. However, the staff noted that adjusting contingent consideration balances at transition date with an adjustment against goodwill includes a catch-up between the balance recognised initially at acquisition date and the balance at transition date. This is inconsistent with the requirements of IFRS 3 (revised 2008) that changes in contingent consideration balances are recognised through profit or loss. Such changes would therefore flow through to retained earnings in the opening statement of financial position.

18. In addition, the staff noted that recognition of adjustments against goodwill at the date of transition is inconsistent with the removal of former paragraph B2(g)(ii) from Business Combinations exemptions in IFRS 1 (see paragraph 8 of this paper).

Recognition of subsequent measurement

19. Some constituents suggested IFRS 1 provides an exemption for the measurement of contingent consideration post-transition.

20. The staff noted that this would be a departure from the focus of IFRS 1. The focus of IFRS 1 is principally on the adjustment required to prepare the opening balance sheet, rather than determining the accounting post-transition.

Overall conclusion

21. The Committee agreed with the staff recommendation not to propose an amendment to IFRS 1 to provide an exemption for first-time adopters on this subject for the reasons set out in paragraphs 12-20.

Question 1 – Committee's recommendation
Does the Board agree with the Committee's recommendation not to propose an amendment through *Annual Improvements* for this issue?

IFRS 8 *Operating Segments* — Determination of scope

Background information

22. In August and November 2009, the Committee received separate requests from the same constituent for the Board to consider issues related to the scope of IFRS 8. Both submissions request clarification of the applicability of IFRS 8 to entities that issue debt or equity instruments to the public, but those instruments are not traded on a 'public market'.

23. More specifically the submissions request respectively:

 (a) that the terminology '**public market**' be clarified; and

 (b) that guidance be provided as to the **determination of when** a reporting entity falls within the scope of IFRS 8, specifically the criteria of 'filing or in the process of filing'.

24. The Committee discussed the issue at its public meeting in March 2010.

Summary of the analysis on these issues

25. The following is a summary of the analysis discussed in March 2010. The staff analysis was set out in agenda paper 7C that can be found on the public website[2].

Clarification of 'public market"

26. The submitter points out that it is overly restrictive to limit IFRS 8 disclosures 'to just those entities whose securities are traded and/ or issued in a public market'. In paragraph 2 of IFRS 8, a public market is described as 'a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets'. In his view this 'will result in non-disclosure of information and non-comparable information between different users'. On the contrary, he believes that 'IFRS 8 should capture all issuers of securities to the public'.

27. The submitter suggests that the words in paragraph 2 of IFRS 8 'in a public market' be changed to 'to the public'. As an alternative, the submitter notes 'the IASB could consider including, as part of the scope of IFRS 8, text along the lines of paragraph 1.3(b) of the definition of "public accountability" from its IFRS for SMEs.' Further, the submitter considers that the definition of 'public accountability' would likely encompass most deposit-taking institutions, however, the submitter 'think[s] that it would be preferable to explicitly require all deposit-taking institutions to fall within the scope of IFRS 8'.

28. The staff noted a potential change increasing the scope of IFRS 8 to be applicable to all entities that issue debt or equity instruments 'to the public' (whether or not currently or planned to trade in the future on a 'public market') has broader implications than is envisaged within the *Annual Improvements* process.

[2] http://www.iasb.org/Meetings/IFRIC+Meeting+March+2010.htm

29. In addition, the staff points out that an entity is never precluded from providing additional information to allow users of those financial statements to evaluate the entity's performance during the period.

How to determine when a reporting entity falls within the scope of IFRS 8

30. This request more specifically relates to the interaction of the scope of IFRS 8 with regulatory filing requirements in circumstances where financial statements are required to be 'filed' only after the entity's debt or equity instruments are issued in a public offering (that is not made in a 'public market').

31. The staff noted that paragraph 2 of IFRS 8 provides 'two limbs' (to use the terminology included in the submissions):

 (a) The **first limb** captures entities 'whose debt or equity instruments are traded in a public market…' [Not the focus of this request]

 (b) The **second limb** captures entities that do not yet have debt or equity instruments that have been issued (and are trading in a public market). Rather, the second limb captures those reporting entities 'that files [presently], or is in the process of filing, its/ the consolidated financial statements with a securities commission or other regulatory organisation <u>for the purpose of issuing</u> any class of instruments in a public market.' (emphasis added).

32. The staff disagreed with the submitter's view that, in circumstances where the entity is only required to file financial statements with a regulator <u>after</u> issuing debt or equity instruments in a public market, that entity does not have to provide IFRS 8 disclosures.

33. In the staff's opinion, the second limb is 'triggered' and becomes applicable based on management's intent to file. The applicability of the second limb is not dependant upon the timing regulatory filing requirements.

Overall conclusion

34. The Committee agreed with the staff recommendation not to add these issues to *Annual Improvements*. The Committee believes these issues go beyond the scope for *Annual Improvements* and would rather include them in a review of the scope of IFRS 8 in a future post implementation review of IFRS 8.

Question 2 – Committee's recommendation
Does the Board agree with the Committee's recommendations not to propose amendments through *Annual Improvements* to address these issues?

Question 3 – Future review of the scope of IFRS 8
Does the Board agree with the Committee's recommendation to include a review of the scope of IFRS 8 in a future post implementation review of IFRS 8?

IAS 32 *Financial Instruments: Presentation* - Clarification of the puttable instruments criteria for income trust units

Background information

35. The Committee discussed a request at its meeting in May 2010 asking for clarification on guidance relating to the classification of puttable financial instruments (puts) that include contractual obligations to provide pro rata distributions. The request proposed an amendment to the guidance in IAS 32 *Financial Instruments: Presentation* as part of the *Annual Improvements Process*. The amendment requested would clarify that a put can be classified as equity if it has a contractual obligation to deliver cash, or another financial asset, to all existing holders of the instrument on a pro rata basis.

Summary of the analysis on these issues

36. The following is a summary of the analysis discussed in May 2010. The staff analysis was set out in agenda paper 14 that can be found on the public website[3].

37. The constituent is of the opinion that because the features of the puts are such that pro rata distributions are to all existing holders and do not result in any changes in their financial position, they should not, in isolation, lead to the put being classified as a liability, rather than equity. They believe that this would be consistent with the Board's recent rationale in issuing the Rights Amendments.

38. In January 2010, the Committee published a final agenda decision relating to the application of the 'fixed for fixed' condition in paragraph 22 of IAS 32. The agenda decision is reproduced below for ease of reference:

> **IAS 32 *Financial Instruments: Presentation* - Application of the 'fixed for fixed' condition**
>
> The IFRIC received requests for guidance on the application of paragraph 22 of IAS 32 which states that 'except as stated in paragraph 22A, a contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument' (often referred to as the 'fixed-for-fixed' condition).
>
> The IFRIC identified that diversity may exist in practice in the application of the fixed-for-fixed condition to other situations in addition to the specific situations identified in the requests.
>
> The IFRIC noted that the Board is currently undertaking a project to improve and simplify the financial reporting requirements for financial instruments with characteristics of equity. A key objective of this project is to develop a better distinction between equity and non-equity instruments. This includes consideration of the current fixed-for-fixed condition in IAS 32.
>
> Consequently, the IFRIC concluded that the Board's current project on Financial Instruments with Characteristics of Equity is expected to address issues relating to the fixed-for-fixed condition on a timely

[3] http://www.iasb.org/NR/rdonlyres/6588BB15-BE48-47AD-9731-765C31AB5232/0/1005ap14obsAIPIAS32Classificationofincometrustunits.pdf

basis. Consequently, the IFRIC decided not to add this issue to its agenda.

39. The staff also noted that the basis of the Board's conclusions relating to the Rights Amendment justified the amendment because:

 (a) such rights were being issued frequently in the current economic environment.

 (b) they are usually relatively large transactions that can have a substantial effect on entities' financial statement amounts.

 (c) this exception to the fixed for fixed condition in IAS 32 is for a narrowly-targeted transaction with owners (shareholders) in their capacity as owners.

40. The staff believes that many of the arguments supporting the decision taken in January 2010 relating to the application of the fixed for fixed condition also apply in considering this request.

Overall conclusion

41. The Committee decided not to propose an amendment to address this issue. This is because:

 (a) the Board clearly identified the unique circumstances that justified the Classification of Rights Issues (Amendment of IAS 32). These unique circumstances do not exist in relation to the fact pattern in this request.

 (b) it could be considered an additional exception to the definition of a financial liability. This would be outside the scope of *Annual Improvements*.

Question 4 – Committee's recommendation
Does the Board agree with the Committee's recommendations not to propose an amendment through *Annual Improvements* to address the issue?