IFRS in Brief

January 2006, **Issue 20**

This issue of *IFRS In Brief* covers the December 2005 meeting of the International Accounting Standards Board (IASB).

KPMG's monthly update on International Financial Reporting Standards (IFRSs)

Summary

At its December 2005 meeting, the Board:

- moved closer to finalising an exposure draft for its income tax convergence project by tentatively deciding:
  - that the fair value of assets and liabilities with tax bases differing from their carrying amounts should be determined as if there were no such difference
  - to require the recognition of deferred tax liabilities and assets relating to goodwill
- discussed draft amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* that would result in equity classification of certain instruments puttable at fair value
- tentatively decided to propose removing the proportionate consolidation option from IAS 31 *Interests in Joint Ventures*
- discussed accounting for insurance contracts with cancellation or renewal options
- discussed its ongoing project on the conceptual framework, which is a joint project with the U.S. Financial Accounting Standards Board (FASB)
- tentatively decided to adopt the definition of fair value proposed in the FASB's draft standard *Fair Value Measurement*
- discussed the possible simplification of the recognition and measurement principles contained in IFRSs as they relate to small and medium-sized entities (SMEs).

Short-term Convergence: Income Tax

The Board discussed several issues relating to its short-term convergence project on income taxes.

The Board tentatively decided that if an asset's or liability's tax base differs from its initial carrying amount, then the fair value of that asset or liability should be determined assuming that its tax base is equal to its fair value, and a deferred tax balance should be recognised for the effect of the difference. This approach would apply to all assets and liabilities acquired, whether as part of a business combination or not, and to differences arising from remeasuring assets and liabilities to fair value.

The Board also tentatively decided to require the recognition of deferred tax assets and liabilities for temporary differences related to goodwill. This decision is based on the assumption that goodwill would be recognised at full fair value as if a 100 percent interest is obtained, which is the approach proposed in the Exposure Draft

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Amendments to IFRS 3 Business Combinations (see *IFRS Briefing Sheet* Issue 29, published in August 2005).

The Board discussed issues relating to allocating tax items between equity and profit or loss, and decided to solicit input on this issue in its exposure draft.

Financial Instruments Puttable at Fair Value

At this meeting, the Board discussed possible amendments to IAS 32 that would result in classifying certain instruments puttable at fair value as equity. Equity classification will be proposed for items that represent the residual interest in the issuer or are payable only on liquidation, provided that they are in the most subordinated class of the issuer's instruments and all instruments in that class have the same rights.

The Board also decided to propose the following:

- The definition of a financial liability would be amended to exclude obligations to deliver a *pro rata* share of the net assets of the entity upon liquidation, including limited life entities and partnership interests. However, this exclusion from financial liability classification would not apply to situations when liquidation of the entity is at the option of a shareholder and not all shareholders within the class have the same rights to initiate liquidation.
- Private entities would be allowed to determine the redemption price of the puttable instruments classified as equity using a formula that approximates fair value.
- Equity classification would not apply if the share of net assets to be received on liquidation is limited or guaranteed.
- Warrants issued on financial instruments puttable at fair value would be classified as liabilities.
- Financial instruments puttable at fair value after a fixed term would be classified as liabilities.
- Non-controlling interests in a subsidiary that are puttable at fair value would continue to be classified as a liability in the group's consolidated financial statements.

Insurance Contracts

The Board discussed accounting for insurance contracts containing cancellation and renewal options, and how, if at all, expectations of policyholders' behaviour should affect the accounting for insurance contracts.

The Board decided that the accounting for a long-term contract with a cancellation option should not be different from the accounting for a short-term contract with a renewal option, provided that the underlying economics of the arrangement (i.e., resulting rights and obligations) are the same. The Board also discussed whether expected cash flows beyond the first year of a contract constitute an asset. The Board did not reach a decision on this issue, but noted that an asset may arise from the contractual rights of the insurer as long as those rights are enforceable.

The Board discussed four possible approaches to accounting for life insurance contracts, two of which were cost-based and two of which were based on current values. The Board decided to focus its future work on current value models. Possible current value approaches are to measure an insurance liability based on what a policyholder would pay for an identical contract, or to measure it based on what the insurer would have to pay to transfer its obligations to another entity.

Conceptual Framework

The Board has identified four sections of this project:

- Phase A: Objectives and quantitative characteristics
- Phase B: Elements, recognition and measurement attributes
- Phase D: Reporting entity
- other phases.

At this meeting, the Board continued its discussion aimed at developing a common conceptual framework with the FASB. Discussion was focused on Phases A, B and D, including cost / benefit constraint issues, and definitions of an asset and a reporting entity.

The Board intends to increase its consideration of cost / benefit constraints, although it will not perform a formal quantitative analysis. The Board also noted that cost / benefit analysis is a persuasive constraint rather than a qualitative characteristic.

The Board discussed a proposed definition of an asset: *"An asset of an entity is a present right, or other access, to an economic resource with the ability to generate favourable cash flows to the entity".* The Board plans to continue refining and testing this definition.

The Board decided that the definition of a reporting entity should focus on an entity's boundaries and not on the existence and needs of external users of the reporting information produced by the entity. The Board asked its staff to research whether a parent-only entity (i.e., a separate entity rather than the consolidated group) is a reporting entity.

Fair Value Measurement

At this meeting, the Board tentatively decided to adopt the definition of fair value proposed by the FASB, as reflected in the working draft of the FASB's standard *Fair Value Measurement* dated 21 October 2005. The draft standard defines fair value as *"the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market* *for the asset or liability"*. While there are some differences between the IFRS and FASB definitions of fair value, the IASB noted that the FASB definition generally is consistent with the fair value measurement objectives in IFRSs. The Board also reviewed the fair value measurement requirements in current IFRSs, and noted that some standards likely would require amendment if the FASB definition is adopted.

Accounting Standards for SMEs

The Board continued discussing possible simplifications to the recognition and measurement principles as they apply to SMEs.

Use of the Effective Interest Method under IAS 39 *Financial Instruments: Recognition and Measurement*

The Board rejected a proposal that straight-line interest accrual be permitted. Instead, the Board decided to propose that the SME standard would require the use of the effective interest method.

Fair Value Measurements under IAS 39

The Board asked the staff to develop a method that would classify financial assets into two categories:

- those that have an observable market price and would be measured at fair value
- others, which would be measured at amortised cost.

Revaluation Model in IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*

The Board decided to propose that the SME standard would allow the use of the revaluation model of accounting, and would direct SMEs to the full versions of applicable standards for further guidance if the fair value option is elected.

Component Depreciation under IAS 16

The Board tentatively decided that the SME standard would not refer to component depreciation. However, SMEs would be allowed to use the component approach contained in the full version of the standard.

Frequency of Remeasurement under IAS 40 *Investment Property*

The Board tentatively decided that the SME standard would allow both the cost model and the fair value model of measuring investment property. However, the fair value model would not require annual valuation.

Other Issues

The Board tentatively decided that no major simplifications or exemptions are needed for SMEs with respect to the following:

- the measurement of share-based payments under IFRS 2 *Share-based Payment*
- the purchase method of accounting for business combinations under IFRS 3 *Business Combinations*
- the recognition and measurement principles of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
- the preparation of cash flow statements under IAS 7 *Cash Flow Statements*
- the requirement for the annual review of residual values and useful lives under IAS 16
- the recognition and measurement requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- the capitalisation of development costs under IAS 38
- the use of the fair value method under IAS 41 *Agriculture*.

Other Projects

The Board also:

- decided to propose removing the proportionate consolidation option from IAS 31, and to reconsider the definition of a joint venture
- reviewed decisions taken at the International Financial Reporting Interpretations Committee (IFRIC) meeting in December, and approved the issue of a final version of IFRIC Interpretation D16 *Scope of IFRS 2*
- reviewed its technical plan
- held an educational session on participation and performance-linked features in insurance and related contracts.

IASB Observer Notes

International Financial Reporting Group has arranged to make available to KPMG member firms' clients and contacts copies of the IASB Observer, a publication of European Research Associates Limited. The IASB Observer provides timely, detailed reporting of IASB meetings. Please talk to your usual local KPMG contact to receive this publication.

If you would like further information on any of the matters discussed in this issue of *IFRS in Brief*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

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