

IFRS in Brief

October 2004

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

Issue 6

This issue of *IFRS in Brief* covers the September 2004 meeting of the International Accounting Standards Board (IASB) and other recent activities of both the IASB and the International Financial Reporting Interpretations Committee (IFRIC).

After a month (August 2004) without a Board meeting the IASB had a heavy agenda in September 2004 including preparation for its joint meeting with the U.S. Financial Accounting Standards Board (FASB) in October 2004. The September 2004 meeting also included, for the first time, public 'educational' sessions for Board members. Topics covered by the IASB in September 2004 include:

- Business combinations – phase I: combinations by contract alone or involving mutual entities;
- Business combinations – phase II: including a possible fair value hierarchy;
- Redeliberations of ED 6 *Exploration for and Evaluation of Mineral Resources*;
- Financial instruments: the fair value option;
- Short-term convergence projects including:
 - IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*;
 - IAS 12 *Income Taxes*; and

- IAS 19 *Employee Benefits* – redeliberations on the proposed changes;
- Reporting by small and medium-sized entities; and
- A research project on joint ventures.

The IASB also discussed possible changes to its deliberative process and a planned project on its conceptual framework.

The IFRIC's recent meetings have led to projects on the following issues being finalised as draft or final interpretations:

- D1 *Emission Rights*;
- D3 *Determining Whether an Arrangement Contains a Lease*;
- D4 *Decommissioning, Restoration and Environmental Rehabilitation Funds*;
- D6 *Multi-employer Plans*;
- D7 *Scope of SIC-12 Consolidation – Special Purpose Entities*;
- D8 *Members' Shares in Co-operative Entities*;

- Service concession arrangements; and
- Provisions for waste, electrical and electronic equipment.

Business combinations – phase I

The Board considered the comment letters received on the Exposure Draft (ED) of *Proposed Amendments to IFRS 3 Business Combinations Combinations by Contract Alone or Involving Mutual Entities*.

The Board decided not to proceed with this project in light of the concerns raised in comment letters about both the timing and the proposed accounting. The Board decided to instead address these issues in its upcoming ED for phase II of its business combinations project.

The Board noted that, if these combinations are outside the scope of IFRS 3, then entities would have to develop accounting policies under the guidance in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Board members expressed concern at the number of respondents who had indicated that they would use the uniting-of-interests method in IAS 22 *Business Combinations* in accounting for such combinations. Board members expressed their view that the IAS 8 hierarchy would not allow an entity to use part of a standard that has been superseded. The Board agreed that a particular warning should be issued in this regard.

The Board discussed other issues, including:

- which transactions were included in combinations ‘by contract alone without the obtaining of an ownership interest’; and
- identifying an acquirer and whether such an entity would meet the definition of a ‘parent’ under IAS 27

Consolidated and Separate Financial Statements. The Board members noted that the intention was that an ‘acquirer’ under IFRS 3 is a ‘parent’ for purposes of IAS 27.

The Board believed that these issues were clarifications of IFRSs that it could address via *IASB Update*.

Business combinations – phase II Combinations of mutual entities

The Board discussed the deliberations of the FASB of the accounting treatment of combinations involving mutual entities. The FASB had investigated whether there were reasons for combinations of mutual entities to qualify for different accounting. Like the FASB, the IASB acknowledged that mutual entities possess some unique characteristics, but decided that the differences between mutual entities and other business entities were not strong enough to justify a different accounting treatment. The Board tentatively decided:

- to require the purchase method of accounting for combinations of two or more mutual entities;
- that no additional guidance should be included in the ED for combinations of mutual entities;
- to include guidance for measuring the fair value of an acquired mutual entity; and
- to require mutual entities to disclose the accounting for the member interests transferred.

The Board also decided that, in a business combination where the acquirer exchanges its own member interests for the member interests of the acquired mutual entity, it would require the fair value of the acquired mutual entity to be presented as a direct addition to the acquirer’s capital or equity account (not retained earnings). Also, the method of

determining the above fair value should be disclosed.

Fair value hierarchy

The FASB and IASB had earlier decided to adopt the fair value hierarchy as a means of helping to ensure consistent fair value measurement in the accounting for business combinations.

In June 2004, the IASB had tentatively decided to expose the FASB’s fair value hierarchy as a separate ED.

At its September 2004 meeting the IASB reconsidered its earlier decision. The IASB also discussed whether and how parts of the FASB’s ED on fair value measurement could be included in its forthcoming ED on business combinations. The IASB decided that in order to avoid delaying its ED on business combinations, it would include limited fair value guidance in the ED based on the FASB document. The Board decided to consider at a later stage whether it should expose a document dealing generally with fair value measurement issues similar to the FASB’s ED on fair value measurement.

Exploration for and evaluation of mineral resources

In July 2004, the Board had considered an IASB staff recommendation to eliminate the special cash-generating unit for exploration and evaluation assets proposed in ED 6. It asked the IASB staff to solicit input on this issue from the IASB’s research team and other industry representative groups. The comment letters received are available on the IASB’s website, www.iasb.org.

The IASB staff suggested an alternative approach, similar to that introduced for goodwill in the 2004 revisions to IAS 36 *Impairment of Assets*. This approach would require management to allocate exploration

and evaluation assets to an appropriate level and test for impairment at this level. The proposal would allow cash-generating units (CGUs) to be aggregated for purposes of the impairment test. The level of aggregation could not exceed a segment as defined in IAS 14 *Segment Reporting*.

The Board intends to issue IFRS 6 *Exploration for and Evaluation of Mineral Resources* in the fourth quarter of 2004.

Financial instruments: the fair value option

The Board considered an analysis of the comment letters received on the ED *Amendments to IAS 39: The Fair Value Option*. A large majority of the respondents, across many categories except regulators, did not support the proposals. The Board decided not to move ahead with the ED as proposed. However, the Board also did not want to revert to IAS 39 *Financial Instruments: Recognition and Measurement* (as revised in March 2004), as this would not address the concerns raised by regulators.

The Board tentatively decided to hold a public meeting of constituents with opposing views and try to develop a solution that would be acceptable to all parties.

Amendments to IAS 37

As part of its short-term convergence project with the FASB, the IASB plans to revise parts of IAS 37.

The Board is seeking to converge the recognition requirements relating to restructuring costs in IAS 37 with those of SFAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*. These amendments also relate to proposed changes to the definitions of contingent assets and liabilities

arising from phase II of the business combinations project.

The Board tentatively decided to omit probability as a recognition criterion from the amended IAS 37 on the basis that it always will be met and is therefore unnecessary. As a result, any item that meets the definition of a provision would be recognised as a liability, unless its amount cannot be measured reliably.

The amendments to IAS 37 in respect of restructuring costs require consequential amendments to the termination benefits requirements in IAS 19 *Employee Benefits*.

The Board decided earlier to modify the recognition of voluntary termination benefits in accordance with IAS 19 to converge with U.S. GAAP. The Board tentatively decided to clarify that voluntary termination benefits are those benefits offered to employees in exchange for a decision to accept voluntary termination. Such benefits must be supplemental to those that the employee ordinarily would be entitled to. This differs from benefits introduced in a long-term plan to encourage employees to accept early retirement, which would not be termination benefits, but plan amendments.

The Board further discussed the measurement of termination benefits. In the interest of convergence the ED proposes that liabilities for termination benefits should be measured at fair value. The Board questioned whether this was appropriate given the use of best estimate assumptions elsewhere. It was noted that under SFAS 146 one-time termination benefits are measured at fair value, but under other standards voluntary termination benefits (i.e., special termination benefits) are measured at the amount of any lump-sum

payments and the present value of any expected future payments. The Board asked the IASB staff to consider alternatives for a converged approach.

Short-term convergence – IAS 12

The IASB staff updated the Board on the short-term convergence project on IAS 12. The IASB and FASB staffs are working to develop a paper for the joint meeting in October 2004, which will include the issues surrounding the recognition of deferred taxes on unremitted earnings of foreign subsidiaries.

The Board was updated about the FASB's upcoming draft interpretation clarifying the recognition of tax benefits under SFAS 109 *Accounting for Income Taxes*. The main objective of this interpretation is to provide guidance on what threshold or confidence level must be met to determine that a temporary difference exists. While both SFAS 109 and IAS 12 provide guidance on the threshold for recognising a deferred tax asset, neither provides guidance on when there is a valid temporary difference between the accounting value and tax base of an item.

The Board decided to add this issue to the scope of the short-term convergence project on income taxes.

Short-term convergence – post-employment benefits

The Board began its redeliberation of the proposals in the ED *Amendments to IAS 19: Actuarial Gains and Losses, Group Plans and Disclosures*.

Recognition of actuarial gains and losses

Despite significant concerns raised in comment letters received, the Board tentatively decided to proceed with the option as proposed in the ED, namely to:

- permit the recognition of actuarial gains and losses in full in the period

in which they occur, outside profit or loss in a statement of recognised income and expense;

- prohibit recycling of actuarial gains and losses recognised in a statement of recognised income and expense;
- require actuarial gains and losses recognised in a statement of recognised income and expense to be recognised immediately in retained earnings; and
- require entities adopting the option to treat the effect of the asset ceiling as an actuarial gain or loss.

Group plans

The Board concluded that the proposals in the ED regarding group plans were too complex. The Board noted that group plans are different from multi-employer plans since group entities should have access to information about the plan as a whole. The Board decided that, in instances where it was possible to allocate the plan reasonably to the various group entities, such entities should be required to apply defined benefit accounting for purposes of their separate financial statements.

Share-based payments

Update on FASB redeliberations

The IASB staff presented a report on the FASB's redeliberations of its March 2004 ED on a revised U.S. standard on accounting for employee share-based compensation.

The IASB staff pointed out that the FASB was currently only considering transactions with employees. The FASB has deferred consideration of share-based transactions with parties other than employees to a later stage.

The IASB staff noted that the Boards had agreed earlier to a convergence project once both Boards had final standards in place.

Scope of IFRS 2 and IFRS 3

The Board clarified an issue concerning the respective scopes of IFRS 2 and IFRS 3.

IFRS 2 *Share-based Payment* scopes out business combinations to which IFRS 3 applies. However, IFRS 3 excludes certain business combinations, (e.g., combinations of entities under common control). IFRS 2 can be read as requiring that business combinations excluded from the scope of IFRS 3 to fall within the scope of IFRS 2.

The Board clarified that its intention was to exclude from the scope of IFRS 2 transactions in which the entity acquires goods as part of the net assets acquired in a business combination *as defined in* IFRS 3, and not just those business combinations within the scope of IFRS 3.

Financial reporting standards for small and medium-sized entities

The Board discussed two alternatives to developing standards for small and medium-sized entities (SMEs):

- IASB standards for SMEs would be primarily a reorganisation of the principles in IFRSs to make the standards more useful to SMEs. This might involve moving material less relevant to SMEs to appendices or omitting the material entirely, with an added requirement for an SME to refer to the relevant IFRS if confronted by an issue not dealt with in the Standards for SMEs; or
- IASB standards for SMEs would be a self-contained and reduced version of IFRSs that includes recognition and measurement principles relevant to the majority of SMEs. In some cases, the principles in these standards might differ from those in IFRSs. There would be no references to full IFRSs, or mandatory or optional 'fallbacks'.

To date, the IASB has reviewed preliminary SME versions of 13 IFRSs, largely based on the first approach. At its September 2004 meeting, the Board concluded that it would not decide which approach to follow until it had considered constituents' comments on the Discussion Paper *Preliminary Views on Accounting Standards for Small and Medium-sized Entities*. This is expected at the October 2004 meeting.

Conceptual framework

In April 2004 the IASB and FASB agreed to develop a project on a shared conceptual framework. This project would involve both Boards revising their existing frameworks to both converge and enhance the existing documents. The Boards are expected to discuss possible approaches and timing at their upcoming joint October meeting.

IASB deliberative process

The IASB is reviewing its deliberative procedures. The IASB's provisional conclusion and proposals were published in the consultation paper *Strengthening the IASB's Deliberative Processes*. The Board received 50 comment letters on the consultation paper. The Board noted that there was strong support for the steps proposed. The International Accounting Standards Committee (IASC) Foundation Trustees will review the IASB's conclusions as part of its broader consideration of possible changes to the Constitution.

Research project on joint ventures

At its July 2004 meeting, the Board discussed a research project on joint venture arrangements which the Australian Accounting Standards Board (AASB) is leading. The Board requested that this project be divided into (i) a short-term project to

remove one of the options in IAS 31 *Interests in Joint Ventures* of using either the equity method or proportionate consolidation; and (ii) a longer-term project aiming to improve and develop the accounting for interests in joint ventures.

At its July 2004 meeting, the Board was undecided about whether to continue with the short-term project. The Board instead agreed to discuss issues with the research team at Board meetings so as to progress the longer-term project.

IFRIC

The finalisation of Draft Interpretation D1 was delayed by IFRIC at the IASB's request, until the Board completed its work on amending IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. The IFRIC noted that the European Union Emissions Trading Scheme is due to start at the beginning of 2005. Given that the IASB's work on IAS 20 will take at least another year to complete, the IFRIC decided that D1 should be finalised substantially in its present form and issued in the November of 2004.

The IFRIC completed its consideration of comments received on Draft Interpretation D3, deciding to include some additional guidance, to modify the transition requirements originally proposed, and to delay the effective date until 1 January 2006. The final interpretation was approved and is expected to be issued in November 2004.

The IFRIC agreed to issue a final revision of Draft Interpretation D4 largely the same as proposed in D4.

The IFRIC continued its discussions of service concession arrangements and is expected to vote on a draft interpretation at its November 2004 meeting.

The IFRIC also approved a draft interpretation in respect of recognising provisions for recycling of waste electrical and electronic equipment. This interpretation is expected to be published in late October 2004 or early November 2004.

The IFRIC considered comments received on Draft Interpretation D6

and decided not to continue with the draft proposed. It will consider possible alternatives in November 2004.

The IFRIC also considered comments received on Draft Interpretation D7 and agreed to issue a final interpretation, largely as proposed, with a change to focus on defined benefit plans.

The IFRIC had a preliminary discussion of comments received on Draft Interpretation D8 and were supportive of proceeding as proposed, while trying to address some of the comments received on remeasurement and reclassification.

IASB Observer notes

The IASB Observer provides timely, detailed reporting of IASB meetings. Copies of the IASB Observer, a publication from European Research Associates Limited, can be obtained by contacting your local KPMG member firm.

If you would like further information on any of the matters discussed in this issue of *IFRS in Brief*, please contact KPMG International Financial Reporting Group or your local KPMG member firm.

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