KPMG

IFRS in Brief

October 2006, **Issue 28**

This issue of *IFRS in Brief* covers the September 2006 meeting of the International Accounting Standards Board (IASB).

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

Summary

At this meeting the Board:

- continued re-deliberating the proposals in the Exposure Draft (ED) of *Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*
- continued discussing issues in relation to the financial statement presentation project
- concluded its substantive discussions on the forthcoming discussion paper on fair value measurements
- discussed the scope of a consultation document on financial instruments, and a definition of financial instrument
- continued discussing phase II of the insurance project
- finished discussing comments received in response to ED 8 *Operating Segments*
- began discussing the application of IAS 24 *Related Party Disclosures* to state-controlled entities
- continued discussing the draft ED of an *IFRS for Small and Medium-sized Entities* (SMEs)
- discussed the definition of reporting entity and the concept of control as part of the conceptual framework project
- discussed the recognition of performance obligations as part of the revenue recognition project
- discussed how to determine the cost of a subsidiary when a parent is a first-time adopter of IFRSs in its separate financial statements
- continued re-deliberating proposals in the ED of *Proposed Amendments to IFRS 3 Business Combinations*.

Provisions

The Board continued re-deliberating proposals in the ED of *Proposed Amendments to IAS 37 and IAS 19*, and:

- reaffirmed that the scope of the amendments should be limited to clarifying the existing measurement principle of IAS 37 and providing application guidance
- reaffirmed that the measurement of a provision should be a current

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settlement concept rather than an ultimate settlement concept
- tentatively decided to provide more application guidance in respect of measurement, but to limit it to the agreed scope of the proposed amendments.

Financial Statement Presentation

The Board continued discussing issues in relation to its financial statements presentation project, and made the following tentative decisions:

- Treasury assets should be included in the financing category rather than in the business category, and financing liabilities and treasury assets should be classified by function rather than by nature.
- Income taxes should be presented as a separate line item in the financial statements, and income tax related to transactions with owners acting in that capacity should not be recognised in the statement of recognised income and expense.
- Discontinued operations should be presented in a separate section of the financial statements; the related assets and liabilities should not be offset; and there should be a single line item in both the income statement and the cash flow statement. Also, the IASB and the U.S. Financial Accounting Standards Board (FASB) should work together on the definition of "discontinued operations" to eliminate differences between IFRSs and U.S. GAAP.
- Information in the statement of recognised income and expense should be presented by function, with supplementary information by nature when necessary.
- Information in the financial statements should be presented gross except when a standard requires net presentation.

Fair Value Measurements

The Board concluded substantive discussions on its forthcoming discussion paper on fair value measurements, which will comprise the recently issued U.S. standard SFAS 157 *Fair Value Measurements*[1] with additional commentary from the Board outlining its preliminary views. The discussion paper, which will be published before the end of 2006, will have a 120-day comment period. At this meeting the Board agreed to highlight the following aspects of SFAS 157 in the discussion paper:

- The fair value of a liability should reflect the risk of non-performance; this guidance is broader than current IFRSs because it extends to non-financial liabilities.
- Fair value is based on exit prices; the Board has not yet completed an analysis of whether this guidance is consistent with each IFRS that uses a fair value concept.
- Fair value is determined by reference to the "principal" market or, in the absence of a principal market, the most "advantageous" market; current IFRSs are not consistent in specifying the reference market.
- When fair value is determined by reference to an active market, block discounts and premiums are ignored; while the Board believes that this guidance is consistent with current IFRSs, it agreed to emphasise that when an active market is available, fair value *must* be determined using that market price.
- Fair value at the date of initial recognition, which is based on an exit price, might differ from the transaction price; the Board has not yet decided whether it agrees with this guidance, but noted that under IAS 39 *Financial Instruments: Recognition and Measurement* generally fair value upon initial recognition is the transaction price.

Financial Instruments

The Board discussed the scope of its planned consultation document on financial instruments, which will include the preliminary views of both the IASB and the FASB, and made the following tentative decisions:

- The scope should be restricted to financial instruments (as defined), but should exclude issues addressed in other projects (e.g., leases).
- Financial instrument should be defined as follows for working purposes: (1) cash; (2) evidence representing a residual or other ownership interest in an entity; (3) a contractual obligation of one party to deliver a financial instrument to a second party and a corresponding contractual right of the second party to require receipt of that financial instrument in exchange for no consideration other than release from the obligation; or (4) a contractual obligation of one party to exchange financial instruments with a second party and a contractual right of the second party to require an exchange of financial instruments with the first party.

The Board also agreed the following in respect of the derecognition of financial instruments under IAS 39 in response to a request from the International Financial Reporting Interpretations Committee (IFRIC):

- Even if derivative financial assets are transferred with non-derivative financial assets, they are not "similar" assets.
- If *all* contractual rights to receive the cash flows inherent in a

1 SFAS 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

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financial asset are transferred, and there has been no transfer of legal ownership, then the transfer is not treated as a pass-through.
- Conditional transfers, including conditions that ensure the existence and value of transferred assets and those that relate to future performance of the asset, do not affect whether or not an entity has transferred the contractual rights to receive cash flows. However, conditions regarding the future performance of the asset could affect the risks and rewards associated with the transferred asset.

Insurance

The Board continued discussing phase II of the insurance project, and made the following decisions in respect of its forthcoming discussion paper:

- No preliminary conclusion in respect of the presentation of the components of changes in insurance liabilities should be included; instead the discussion should make reference to the financial statements presentation project.
- Differences between the insurance accounting model in accounting for investment contracts, and the models used in IAS 18 *Revenue* and IAS 39, will be highlighted; the Board will discuss later whether and how the models should be converged.
- The Board reaffirmed its previous decision to use a portfolio approach to measuring and recognising risk margins, rather than a specific contract approach.

The Board also:

- asked the staff to do further research in respect of the unbundling of insurance contracts, the presentation of profit or loss and equity attributable to policyholders, and universal life contracts
- held an educational session on insurance contracts with representatives of the CFO Forum, the Group of North American Insurance Enterprises, and four major Japanese life insurers.

Segment Reporting

The Board finalised its discussions on comments received in response to ED 8 *Operating Segments*. It agreed that the forthcoming standard will apply to annual periods beginning on or after 1 January 2009. At this meeting the Board decided to make the following changes to the proposals in the ED:

- A measure of segment liabilities should be disclosed if it is provided to the chief operating decision maker (CODM).
- The revenue disclosures proposed for interim financial statements should be required only if that information is provided to the CODM.

Related Party Disclosures

The Board began its discussions on the application of IAS 24 to state-controlled entities, and made the following tentative decisions:

- Relief should be provided in respect of related party relationships that arise through common control by the State.
- The term "State" should not be defined because it is a country specific issue.
- The proposed amendments should include indicators of a related party relationship with the State.

Small and Medium-sized Entities

The Board continued discussing the draft *IFRS for SMEs* and made a number of decisions, including the following:

- In respect of hedge accounting, the ED will propose a short-cut method for effectiveness testing under which effectiveness would be assumed if certain criteria are met; the accompanying discussion will include potential alternatives to such an approach.
- In respect of defined benefit plans, the ED will propose the immediate recognition of all actuarial gains and losses in profit or loss.
- In respect of income taxes, the ED will propose a "temporary differences" approach, but excluding deferred taxes on the unremitted earnings of foreign subsidiaries, associates and joint ventures unless it is probable that the temporary difference will reverse in the foreseeable future.

Conceptual Framework

The Board re-deliberated the definition of reporting entity and the concept of control, and agreed that the conceptual framework should focus on concepts. The Board tentatively decided the following:

- It should not specify which entities must prepare general purpose external financial reports.
- The term "reporting entity" should not be defined specifically, but it should not be limited to a legal entity.
- A group should be regarded as a separate entity for financial reporting purposes; and a combination of entities may comprise a reporting entity if they are all controlled by the same party.
- Control should be based on *present* facts and circumstances, and therefore should include temporary control.
- Control should not be limited to circumstances in which the entity has sufficient *legal* rights to direct the financing and operating policies of another entity.
- An entity can be controlled by only one other entity.
- An option does not confer control; rather, the asset is the right to receive delivery of the underlying asset when the option is exercised.

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Revenue Recognition

The Board continued discussing a model of revenue recognition based on customer consideration and performance to date. The Board used an example of the sale of a car and a separate two-year warranty, and discussed how to recognise the revenue from the warranty. Two approaches were considered, but no decisions were made:

- Under the first approach, all estimates related to the seller's performance obligation would be made at the date of the sale and would not be revised unless IAS 37 would require a higher provision.
- Under the second approach, the seller's performance obligation would be remeasured at each reporting date based on current estimates of future cash flows at that date.

First-time Adoption and the Deemed Cost of a Subsidiary

The Board agreed to propose the following relief for the first-time adoption of IFRSs by a parent in its separate financial statements:

- Instead of restating the cost of an investment in a subsidiary, a parent could choose to measure the cost at an amount equal to either of the following at the date of transition:
  - the carrying amount of the net assets of the subsidiary under IFRSs; or
  - the fair value of the subsidiary.
- For the purpose of applying the cost method in IAS 27 *Consolidated and Separate Financial Statements* subsequently, pre-acquisition profits should be deemed to be equal to:
  - the cumulative amount of profits at the date of transition, if the parent elects the above relief; or
  - the amount of pre-acquisition profits determined under previous GAAP.

Business Combinations

The Board continued re-deliberating proposals in the ED of *Proposed Amendments to IFRS 3 Business Combinations*, and made the following tentative decisions in respect of intangible assets:

- Intangible assets should be recognised separately from goodwill if they are "identifiable" and can be measured reliably.
- The valuation of intangible assets should be market-based rather than entity specific.

Other

The Board also:

- received an update on IFRIC activities, noting that the following would be presented to the Board at its October meeting: final interpretations on service concessions and the application of IFRS 2 *Share-based Payment* to group and treasury share transactions; a draft interpretation on accounting for real estate sales
- received a summary of the comment letters to the Canadian discussion paper *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*
- agreed to investigate adding a project to its agenda on investment risk, and in particular country specific disclosures
- held an educational session on the consolidation of special purpose entities
- discussed an updated technical plan and project timetables, which will be available on the IASB's Web site; the Board noted that it was important to deliver on its stated timetable.

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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