

## Board Meeting Highlights

The International Accounting Standards Board met in Paris, France, on 18 – 20 December 2001, where it discussed:

- Business Combinations;
- Improvements to Existing IASB Standards;
- Insurance Contracts; and
- SIC Interpretations.

### Business Combinations (Phase I)

At the September 2001 meeting, the Board tentatively agreed that impairments of goodwill should be identified in the same way as under IAS 36, *Impairment of Assets*; that is, by comparing the recoverable amount of the smallest group of cash-generating unit(s) to which goodwill can be allocated on a reasonable and consistent basis with the carrying amount of the unit(s). If an impairment is identified in this way, it would then be measured by:

- first, allocating the recoverable amount of the unit(s) to the fair value of the net assets that would be identified and recognised if the unit(s) were acquired to give an implied value of goodwill in the unit(s); and
- then, comparing the implied value of goodwill with its carrying amount.

The Board considered at this meeting whether proceeding with the above impairment test might in some way limit future decisions the Board could make about the impairment testing of other assets. The Board concluded that possible decisions about the impairment testing of other assets would not be constrained by the above impairment test for goodwill. The Board therefore agreed to proceed with the above impairment test for goodwill and to consider the question of impairment of other assets in a later project. The Board did, however, tentatively agree that the

rules for allocating an impairment loss across the assets in a unit currently in IAS 36 should be amended so that the impairment loss attributed to goodwill is consistent with the impairment loss calculated under the new goodwill impairment test.

The Board also made a number of other tentative decisions about the impairment test for goodwill. In particular, the Board tentatively agreed that:

- an impairment loss should not be recognised for goodwill to the extent that it arises because an intangible asset, that did not meet the criteria for recognition separately from goodwill at the time of acquisition, subsequently meets that criteria and would be allocated a separate fair value when calculating the implied value of goodwill;
- no amendment should be made to the rules currently in IAS 36 for allocating an impairment loss across the assets in a unit in order to reflect the effect of unrecognised increases in the value of liabilities; and
- since the amount of goodwill attributable to minority interests as at the date of acquisitions is not recognised, the impairment test for goodwill should be such that the minority interest in goodwill is prevented from acting as a buffer against the identification and measurement of goodwill impairments.

The Board discussed its previous decision to require, for any business combination, contingent liabilities of the acquiree (as defined in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*) to be identified and recognised at their fair values as part of the apportionment of the cost of acquisition, provided those fair values can be reliably measured. The Board reconfirmed its previous decision and tentatively agreed that contingent

liabilities of the acquiree so recognised should:

- be initially measured at their fair values, being the present value of amounts expected to be disbursed in meeting the liability, determined at appropriate current interest rates; and
- continue to be measured subsequent to initial recognition at their fair values, with changes in fair value recognised in the income statement.

The Board discussed its previous decision to require any negative goodwill remaining after a reassessment of the identification and measurement of the identifiable net assets acquired to be accounted for by: first, reducing the carrying amounts recognised in respect of certain of the acquiree's identifiable net assets for which the valuation may not be so reliable as for assets traded in an active market; and then, recognising any remaining excess immediately in the income statement as a gain. The Board noted the working principle it agreed with the FASB in November 2001 to adopt as the basis for the IASB/FASB joint project on issues related to the application of the purchase method. The Board tentatively agreed that, in light of that working principle, it should amend its previous tentative decision in relation to the accounting for negative goodwill.

(continued...)

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## **Business Combinations (Phase I) (continued)**

Therefore, the Board tentatively agreed that any negative goodwill remaining after a reassessment of the identification and measurement of the identifiable net assets acquired should be recognised immediately in the income statement as a gain.

The Board also considered the date on which equity instruments issued as consideration in a business combination should be measured, and agreed to adopt an agreement date model. Under that model:

- equity instruments issued as consideration in a business combination are measured at their market price on the agreement date, which is the date that a substantive agreement between the parties is reached and, in the case of publicly listed entities, announced to the public. In the case of a hostile takeover, the Board tentatively agreed that the earliest date that a substantive agreement between the parties is reached is the date on which the number of the acquiree's shareholders to have accepted the acquirer's offer is sufficient to cause control of the acquiree to pass to the acquirer; and
- measurement should, in certain circumstances, include an assessment of the market price of the equity instruments for a reasonable number of days before the agreement date. However, the market price after the agreement date should not be considered.

The Board will consider a range of follow-on issues related to the agreement date model at a future meeting.

## **Improvements to Existing IAS**

### **IAS 1, *Presentation of Financial Statements***

The Board tentatively agreed the following:

- to articulate the hierarchy of IASB pronouncements, non-mandatory guidance, and other sources of accounting guidance;
- to revise IAS 1, paragraph 53, so that the presentation of assets and liabilities as current or non-current on the face of the balance sheet would be required unless an unclassified basis of presentation is more appropriate;
- to amend IAS 1, paragraph 63, so that an agreement to refinance, or reschedule payments on, a liability which is completed after the balance sheet date but before the financial statements are authorised for issue would not be taken into account in the liability's classification;
- to amend IAS 1, paragraph 65, so that when a liability is payable on demand at the balance sheet date, a lender's agreement not to demand payment which is given after the balance sheet date but before the financial statements are authorised for issue would not be taken into account in the liability's classification;
- to require disclosure of any defaults on principal, interest, sinking fund or redemption obligations during the period in respect of loans payable, and any other breaches of loan agreements that can cause the lender to demand repayment, if those breaches exist at the balance sheet date;
- to consider disclosure related to the uncertainties regarding measurement of items recognised in the financial statements that have the potential to affect significantly the financial statements;

- to modify the existing disclosure requirement for a payment analysis to require disclosure of total required payments for each of the next five years, and later than five years, in respect of financial liabilities (under IAS 32, *Financial Instruments: Disclosure and Presentation*) and future lease payments (under IAS 17, *Leases*); and
- to require for existing IAS disclosure of comparative information for current period disclosures in financial statements, including reconciliations of opening and closing balances of classes of property, plant and equipment and intangible assets.

### **IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies***

The Board tentatively agreed to prohibit the classification of items of income or expense as 'extraordinary items'. Therefore, no items of income or expense are to be presented as being distinct from the ordinary activities of the enterprise.

In addition, the Board reaffirmed the following tentative decisions made in June 2001:

- a change in an accounting estimate should be recognised in current income. The Standard will provide further information on how to distinguish a change in estimate from a change in accounting policy;
- discretionary changes in accounting policy should be accounted for as a retrospective restatement of prior periods; and
- there should be no distinction between degrees of error in financial statements and that all material errors should be corrected by restating the prior period in which the error occurred.

### **IAS 17, *Leases*, and IAS 40, *Investment Property***

The Board considered two limited improvements to IAS 17 and IAS 40. It should be noted that, in the light of the Board's wider project on leases, it has decided not to consider any other possible changes to IAS 17 in the improvements project.

#### *Initial direct costs incurred by lessors*

The Board considered whether to eliminate the choice in IAS 17 on how a lessor accounts for initial direct costs incurred in negotiating a lease.

The Board decided that it should consult with liaison standard-setters in January 2002 before it takes a final decision on this issue. Its tentative view was that, for reasons of convergence and comparability with other international accounting standards, initial direct costs should be capitalised and allocated over the lease term. That is, the Board's tentative view was that it should remove the option of recognising such costs as an expense when incurred and of allocating them over the lease term by recognising the cost as an expense and, in the same period, recognising an equal amount of unearned finance income.

The Board also agreed that, whatever is decided in the improvements project, it should revisit the issue as part of the wider question of how an asset should be measured on initial recognition, agenda priorities permitting.

#### *Long-term leases of property*

The Board considered the treatment of long-term property leases under IAS 17 and IAS 40. IAS 17 presently requires that a lease of land must be classified as an operating lease, unless

title is expected to pass to the lessee by the end of the lease term. In turn, this prevents the lessee from classifying its interest in the lease as an investment property under IAS 40. That is, the lessee does not record an investment property that it can remeasure to fair value.

The Board tentatively decided to amend the definition of an investment property in IAS 40, paragraph 4, so that a lessee in a qualifying property lease would classify its investment as an investment property provided that:

- the rest of the definition of an investment property is met; and
- the lessee uses the fair value model in IAS 40, paragraphs 27 – 49.

In such a case, the lessee should account for the lease as if it were a finance lease.

The Board also decided to consider two further issues at a future meeting:

- whether it should remove the choice in IAS 40 between using the fair value model and the cost model for investment properties; and
- whether it should clarify that, in classifying a lease as a finance or operating lease under IAS 17, a lease of land and buildings should be split into two components – a lease of land and a lease of buildings – and each element assessed separately.

#### **IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries**

The Board tentatively agreed the following:

- further consideration should be given to whether to withdraw the exemption from preparing consolidated financial statements. One possibility to be considered is retaining the current exemption, but with certain modifications;
- the measurement of investments in subsidiaries in a parent's separate financial statements should be considered at a subsequent meeting, together with the issue of possible exemptions from preparing consolidated financial statements in some circumstances;
- IAS 27 should require minority interests to be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity. The Basis for Conclusions should indicate that this change does not prejudice issues regarding minority interest transactions and that the Board does not expect any change in recognition and measurement of minority interests at this time. Questions about recognition and measurement of minority interests are being addressed in the business combinations project (phase II);
- SIC-12, *Consolidation – Special Purpose Entities*, should not be incorporated into IAS 27. SIC-12 should be reconsidered in a subsequent project; and
- SIC-33, *Consolidation and Equity Method - Potential Voting Rights and Allocation of Ownership Interests*, should be incorporated into IAS 27.

#### **IAS 28, Accounting for Investments in Associates**

The Board tentatively agreed the following:

- guidance should be provided on circumstances in which the presumption that an investor has significant influence where the investor holds 20% or more of the voting power of the investee may be overcome. Disclosure should be required of the reasons why the presumption is overcome;

- the measurement of investments in associates in an investor's separate financial statements should be considered at a subsequent meeting, together with the measurement of investments in subsidiaries. IAS 28 permits three alternatives;
- IAS 28 should require the interest in an associate to include amounts such as advances. This affects the base to be reduced when an associate incurs losses. SIC-20, *Equity Accounting Method – Recognition of Losses*, should be withdrawn; and
- SIC-3, *Elimination of Unrealised Profits and Losses on Transactions with Associates*, and SIC-33, *Consolidation and Equity Method - Potential Voting Rights and Allocation of Ownership Interests*, should be incorporated into IAS 28.

#### **Venture Capital Investments**

The Board tentatively agreed that venture capital investments should not be accounted for using the equity method or proportionate consolidation under IAS 28 and IAS 31, *Financial Reporting of Interests in Joint Ventures*, and should instead be measured at fair value as a financial asset held for trading under IAS 39, *Financial Instruments: Recognition and Measurement*. The Board noted that, if a venture capital investee qualifies as a subsidiary under IAS 27, the investment should be consolidated without exceptions. The Board will consider how to define venture capital investments at a subsequent meeting.

#### **IAS 39, Financial Instruments: Recognition and Measurement**

The Board considered proposals for amendments to the derecognition provisions in IAS 39 that had been developed in consultation with the IAS 39 Implementation Guidance Committee (IGC).

The Board tentatively agreed the following:

##### *Financial Assets*

- to clarify the derecognition provisions in IAS 39 by establishing as the guiding principle a continuing involvement approach that disallows derecognition to the extent to which the transferor has continuing involvement in an asset or a portion of an asset it has transferred. A transferor has a continuing involvement when:
  - it could or could be required to reacquire control of the transferred asset (for example, if the financial asset can be called back by the transferor, the transfer does not qualify for derecognition to the extent of the asset that is subject to the call option); or
  - compensation based on the performance of the transferred asset will be paid (for example, if the transferor provides a guarantee, derecognition is precluded up to the amount of the guarantee).
- not to accommodate exceptions from the general principle, including:
  - the notion in IAS 39, paragraph 38, that the transferor must not retain substantially all of the risk and returns of certain assets in order for any portion of those assets to qualify for derecognition; and
  - the transferee 'right to sell or repledge' condition for derecognition.
- to eliminate the special rules for transfers where fair value cannot be reliably measured;
- to provide guidance dealing with pass-through arrangements. When the transferor continues to collect cash flows from the transferred asset, additional conditions must

be met in order for a transfer to qualify for derecognition, including:

- the transferor has no obligation to pay cash flows to the transferee unless it collects equivalent cash flows from the transferred asset;
  - the transferor cannot use the transferred asset for its benefit; and
  - the transferor is obligated to remit any cash flows it collects on behalf of the transferee on a timely basis.
- to provide guidance on accounting for collateral, including:
- if the transferee has the ability to sell or repledge collateral received, the transferor reclassifies the collateral in its balance sheet (for instance, as receivables pledged);
  - if the transferee sells the collateral received, the transferee records a liability for the obligation to return the collateral; and
  - if the transferor defaults and is no longer entitled to the transferred asset, the transferor derecognises the asset and the transferee recognises the asset.
- to incorporate key conclusions in existing IAS 39 implementation guidance on the application of the derecognition provisions into IAS 39 itself;
- to review the need for additional disclosures, for instance, in the case of securitisations.

#### *Financial Liabilities*

- to incorporate key conclusions in existing IAS 39 implementation guidance on the application of the derecognition provisions into IAS 39 itself.

## **Withdrawal of IAS 15**

The Board tentatively agreed to withdraw IAS 15, *Information Reflecting the Effects of Changing Prices*. IAS 15 encourages, but does not require, certain disclosures of information reflecting the effects of changing prices. The Board noted that there appears to be no current need for an International Accounting Standard encouraging the disclosure of such information.

## **SIC Interpretations**

The Board approved the following final SIC Interpretations:

- SIC-27, *Evaluating the Substance of Transactions in the Legal Form of a Lease*;
- SIC-28, *Business Combinations – “Date of Exchange” and Fair Value of Equity Instruments*;
- SIC-29, *Disclosure – Service Concession Arrangements*;
- SIC-30, *Reporting Currency – Translation from Measurement Currency to Presentation Currency*;
- SIC-31, *Revenue – Barter Transactions Involving Advertising Services*; and
- SIC-33, *Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests*.

In approving SIC-28, the Board noted SIC’s interpretation of the existing requirements of IAS 22, *Business Combinations*. The Board also noted that it is considering in phase one of its business combinations project the date on which equity instruments issued as consideration should be measured. Any possible change to the existing requirements as result of this project would only be effective after the Board has completed its due process.

During its discussion of SIC-30, the Board noted that the Interpretation is consistent with its tentative decision in November to require translation of financial statements into a presentation currency using the method set out in IAS 21, *The Effects of Changes in Foreign Exchange Rates*, paragraph 30. To the extent that a measurement currency (or, as the Board has tentatively agreed to describe it, the functional currency) is the currency of a hyperinflationary economy, the Board concurred with the SIC that the closing rate existing at the date of the most recent balance sheet presented should be applied to all items in all balance sheets and income statements presented.

The Board considered, but did not approve proposed final SIC Interpretation 32, *Intangible Assets – Web Site Costs*, and SIC Interpretation 34, *Financial Instruments – Instruments or Rights Redeemable by the Holder*. In respect of proposed final Interpretation 32, the Board considered it important for the proposed treatment of initial graphic design costs to converge if possible with that required by interpretive groups sponsored by the liaison national standard setters – all of which require such costs to be included in the costs of the web site. The Board requested that the SIC consider holding a public teleconference meeting to reopen this one aspect for further discussion.

The divergent views expressed by respondents to SIC-D34 were relayed to the Board. The Board discussed proposed final Interpretation 34 and agreed to address the issue in its Improvements Project on IAS 32, rather than approve the issuance of an Interpretation.

## **Insurance Contracts**

The Board continued its discussion of chapter 3 of the Draft Statement of Principles (DSOP) prepared by the former IASC Insurance Steering Committee. Chapter 3 deals with measurement objectives. The Board then began its discussion of chapter 4 (estimating the amount and timing of future cash flows). Chapters 1 to 6 are available on the IASB’s web site. The rest of the DSOP is being finalised and will be posted in January and February 2002.

Pending further discussion of other chapters of the DSOP, the Board did not attempt to reach a conclusion on the following proposal in chapter 3:

- while IAS 39, *Financial Instruments: Recognition and Measurement*, is still in place, insurance liabilities and insurance assets should be measured at entity-specific value. Entity-specific value represents the value of an asset or liability to the enterprise that holds it, and may reflect factors that are not available (or not relevant) to other market participants. In particular, the entity-specific value of an insurance liability is the present value of the costs that the enterprise will incur in settling the liability with policyholders or other beneficiaries in accordance with its contractual terms over the life of the liability;
- if a successor standard to IAS 39 introduces fair value measurement for the substantial majority of financial assets and liabilities, IASB should consider introducing fair value measurement for all insurance liabilities and insurance assets. Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm’s length transaction. In particular, the fair value of a liability is the amount that the enterprise would have to pay a third party at the balance sheet date to take over the liability.

As a working hypothesis to guide its further work, the Board agreed in broad terms with the following principles in chapters 3 and 4:

- the entity-specific value or fair value of insurance liabilities should not be affected by the type of assets held or by the return on those assets (unless the amount paid to policyholders is directly influenced by the return on specified assets, as with certain performance-linked contracts, to be discussed in chapter 7);
- overstatement of insurance liabilities in general purpose financial statements should not be used to impose implicit solvency or capital adequacy requirements; and
- deferred and fund methods of accounting should not be used. Deferred and fund methods recognise premium revenue and claims expense at a predetermined time (for example, three years) after the end of the underwriting year, or as soon as premiums, claims, and expenses can be reliably measured. Until that time, premiums received (less claims and expenses paid) are reported in the balance sheet as a fund. If the fund is deficient, the loss is recognised immediately.

The Board discussed, but did not attempt to conclude on, the proposals that:

- the starting point for measuring insurance assets and insurance liabilities should be the expected present value of all future pre-income-tax cash flows arising from the contractual rights and contractual obligations associated with the closed book of insurance contracts; and
- cash flows arising from the contractual rights and obligations associated with the closed book of insurance contracts should include cash flows from future renewals to the extent, and only to the extent, that:
  - their inclusion would increase the measurement of the insurer's liability; or
  - policyholders hold uncancellable renewal options that are potentially valuable to them. A renewal option is potentially valuable if, and only if, there is a reasonable possibility that it will significantly constrain the insurer's ability to reprice the contract at rates that would apply for new policyholders who have similar characteristics to the holder of the option.

The Board will continue its discussion of chapter 4 in January 2002.