BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

November 2003

The International Accounting Standards Board met in London on 18 and 19 November 2003, when it discussed:

- Business combinations
- Employee benefits
- Financial instruments
- Improvements to IFRSs
- Insurance contracts
- Leases
- Share-based payment
- Reporting comprehensive income.

Business Combinations (phase I)

Definition of joint control

The Board considered whether it should amend the current definition of 'joint control' in IAS 31 *Financial Reporting of Interests in Joint Ventures*. The Board had agreed at its June 2003 meeting to explore this issue because it remained concerned that its decision to eliminate the pooling of interests method would create incentives for business combinations to be structured to meet the definition of a joint venture. As part of this consideration, the Board reviewed the following definition proposed in the 1999 G4+1 paper *Reporting Interests in Joint Ventures and Similar Arrangements*:

> *Joint control over an enterprise exists when no one party alone has the power to control its strategic operating, investing, and financing decisions, but two or more parties together can do so, and each of the parties sharing control (joint venturers) must consent.*

Board members expressed some concern that the IAS 31 definition of joint control (ie "the contractually agreed sharing of control") could result in the requirement to apply the purchase method being circumvented when a business combination involves the owners of multiple businesses (for example, multiple medical practices) agreeing to combine their businesses into a new entity (sometimes referred to as 'roll-up transactions'). In such circumstances, the owners of the combining businesses could avoid the requirement to apply the purchase method by contractually agreeing that all the essential strategic operating, investing, and financing decisions require the consent of a majority of the owners. Board members agreed that, in the absence of a contractual agreement requiring unanimous consent to strategic operating, investing and financing decisions of the parties sharing control, such transactions should be accounted for by applying the purchase method.

Therefore, the Board agreed to amend the definition of joint control in IAS 31 (and IAS 28 *Investments in Associates*) so that joint control over an economic activity exists only when the strategic financial and operating decisions relating to the activity contractually require the unanimous consent of the parties sharing control (the venturers). This differs from the definition proposed as a consequential amendment in the Exposure Drafts issued as part of phase I of the Business Combinations project. In particular, the definition proposed as a consequential amendment in the Exposure Drafts could be read to have resulted in a joint venture existing only if unanimous consent was required for *all* (rather than just strategic) financial and operating decisions. The Board agreed with respondents' comments that requiring unanimous consent on all such decisions would narrow by too much the type of arrangements meeting the definition of a joint venture.

Definition of an operation

During the balloting process for ED 3, some Board members recommended that the future IFRS arising from ED 3 should include guidance on identifying when a group of assets or net assets comprises an operation and when, therefore, the acquisition of a group of assets or net assets should be accounted for using the purchase method. This issue was also raised by many respondents to ED 3 and by many of the field visit participants. As a result, the Board considered at this meeting whether, and if so, what, additional guidance should be included in the final IFRS on identifying when an entity or a group of assets or net assets constitutes an 'operation'.

The Board agreed that:

- all references in ED 3 to 'operations' should be replaced in the IFRS with 'businesses'.
- a definition of a business should be included in the IFRS. That definition should state that a business is an integrated set of activities and assets conducted and managed for the purpose of providing a return to investors or lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are, or will be, used to generate revenues. If a transferred set of activities and assets includes goodwill, the transferred set shall be presumed to be a business.

The Board also agreed to relocate paragraph 14 of ED 3 to the beginning of the section in ED 3 titled "Identifying a business combination" and amend it as follows:

> "The result of nearly all business combinations is that one entity, the acquirer, obtains control of one or more other ~~entities or operations~~ businesses, the acquiree. If an entity obtains control of one or more other

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Business combinations (phase I) *(continued)*

entities that are not businesses, the bringing together of those entities is not a business combination. When a group of assets that does not constitute a business is acquired, the cost of the group of assets shall be allocated between the individual identifiable assets in the group based on their relative fair values."

Subsequent measurement of contingent liabilities

The Board reconsidered its proposal in ED 3 that contingent liabilities recognised as part of allocating the cost of a combination should be measured after initial recognition at fair value, with changes in fair value recognised in profit or loss. Board members noted that this proposal is inconsistent with the accounting for financial guarantees and commitments to provide loans at below-market interest rates under the proposed improvements to IAS 39 *Financial Instruments: Recognition and Measurement.*

The Board agreed to amend the proposal in paragraph 46 of ED 3 for consistency with IAS 39. Therefore the IFRS will require contingent liabilities recognised as part of allocating the cost of a combination to be measured subsequently at the higher of (a) the amount that would be recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (b) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.

The Board also agreed to clarify that:

- the requirement in the IFRS on the subsequent measurement of contingent liabilities does not apply to contracts accounted for in accordance with IAS 39.
- loan commitments excluded from the scope of IAS 39 that are not commitments to provide loans at below-market interest rates are accounted for as contingent liabilities of the acquiree if, at the acquisition date, it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation or if the amount of the obligation cannot be measured with sufficient reliability. Such a loan commitment is recognised separately as part of allocating the cost of a combination only if its fair value can be measured reliably.

Measuring value in use

The Board considered two issues referred to it by the IFRIC and also raised by respondents to the Exposure Draft of Proposed Amendments to IAS 36 *Impairment of Assets*. Both issues relate to the application of paragraphs 27(b) and 37 of IAS 36, which were not reconsidered by the Board when developing the Exposure Draft.

Paragraph 27(b) requires the cash flow projections used to measure value in use to be "based on the most recent financial budgets/forecasts that have been approved by management." Paragraph 37 requires the future cash flows to be "estimated for the asset [or cash-generating unit] in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from: (a) a future restructuring to which an entity is not yet committed; or (b) future capital expenditure that will improve or enhance the asset [or cash-generating unit] in excess of its standard of performance assessed immediately before the expenditure is made."

The first issue the Board considered relates to the acquisition of a cash-generating unit when:

(a) the price paid for the unit was based on projections that included a major restructuring expected to result in a substantial increase in the net cash inflows derived from the unit; and

(b) there is no observable market from which to estimate the unit's net selling price.

Concern has been expressed that if the net cash inflows arising from the restructuring are not reflected in the unit's value in use, comparison of the unit's recoverable amount with the carrying amount immediately after the acquisition will result in the recognition of an impairment loss.

The Board agreed that, all else being equal, the value in use of a newly acquired unit will, under IAS 36, be less than the price paid for the unit to the extent that the price includes the net benefits of either a future restructuring to which the entity is not yet committed or future capital expenditure that will improve or enhance the unit in excess of its standard of performance assessed immediately before the expenditure is made. However, this does not mean that a comparison of the unit's recoverable amount and carrying amount immediately after the acquisition will result in the recognition of an impairment loss. The Board observed that:

- Recoverable amount is measured under IAS 36 as the higher of value in use and net selling price. Net selling price is defined in IAS 36 as "the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal."
- There is no requirement in IAS 36 for net selling price to be estimated by reference to an observable market. The best evidence of a recently acquired unit's net selling price would be the arm's length price the entity paid to acquire the unit, adjusted for disposal costs and for any changes in economic circumstances between the transaction date and the date at which the estimate is made.
- If the unit's net selling price were to be otherwise estimated, it would have to reflect the market's assessment of any net benefits to be derived from restructuring the unit or from future capital expenditure on the unit.

Therefore, all else being equal, the unit's recoverable amount would be its net selling price, rather than its value in use. As such, the net benefits of the restructuring or future capital expenditure would be reflected in the unit's recoverable amount, meaning that an impairment loss would arise only to the extent of any material disposal costs.

The Board agreed that:

- amending IAS 36 to include in value in use calculations the costs and benefits of future restructurings to which the entity is not yet committed and future capital expenditure that will improve or enhance the asset in excess of its standard of performance assessed immediately before the expenditure is made would represent a significant change to the concept of value in use adopted IAS 36. That concept currently is 'value in use for the asset in its current condition'.
- the concept of value in use currently in IAS 36 should not be modified as part of the Business Combinations project, but should be modified only once the Board considers and

resolves the issue of the appropriate measurement objective(s) in accounting more broadly.

The second issue the Board considered relates to what some have suggested is a conflict between the requirements in paragraphs 27(b) and 37 of IAS 36. Paragraph 27(b) requires value in use to be based on the most recent forecasts approved by management—which would be likely to reflect management's intentions in relation to future restructurings and future capital expenditure—whereas paragraph 37 requires value in use to exclude the effects of future restructurings to which the entity is not yet committed and future capital expenditure that will improve or enhance the asset in excess of its standard of performance assessed immediately before the expenditure is made.

The Board concluded that it is clear from the existing Basis for Conclusions to IAS 36 that the IASC's intention was for value in use to be calculated using estimates of future cash inflows for an asset in its current condition. Nevertheless, the Board agreed that the requirement in paragraph 27(b) for value in use to be based on the most recent forecasts approved by management could be viewed as inconsistent with paragraph 37. Therefore the Board agreed to amend paragraph 27(b) of IAS 36 to clarify that those forecasts should exclude future restructurings to which the entity is not yet committed and future capital expenditure that will improve or enhance an asset in excess of its standard of performance assessed immediately before the expenditure is made.

Measuring value in use using pre-tax cash flows and pre-tax discount rates

The Board considered the current requirements in IAS 36 for:

- income tax receipts and payments to be excluded from the estimates of future cash flows used to measure value in use; and
- the discount rate used to measure value in use to be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.

The Board did not reconsider these requirements when developing the Exposure Draft of Proposed Amendments to IAS 36. However, a number of field visit participants[1] and respondents to the Exposure Draft stated that using pre-tax cash flows and pre-tax discount rates would represent a significant implementation issue for companies because typically a company's accounting and strategic decision-making systems are fully integrated and use post-tax cash flows and post-tax discount rates to arrive at present value measures.

The Board observed that the definition of value in use in IAS 36 and the associated requirements on measuring value in use are not sufficiently precise to give a definitive answer to the question of what tax attribute an entity should, under IAS 36, reflect in value in use. For example, although IAS 36 specifies discounting pre-tax cash flows at a pre-tax discount rate—with the pre-tax discount rate being the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows—IAS 36 does not specify which tax effects the pre-tax rate should include. Arguments could be mounted for various approaches.

The Board also observed that the Basis for Conclusions to IAS 36 clarifies that, "[i]n theory, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, as long as the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows. The pre-tax discount rate is not always the post-tax discount rate grossed up by a standard rate of tax."

The Board agreed that:

- any decision to amend the requirement in IAS 36 for pre-tax cash flows to be discounted at a pre-tax discount rate should be made only after the Board has resolved the issue of what tax attribute should be reflected in value in use. However, the Board should not try to resolve this latter issue as part of the Business Combinations project—decisions on the treatment of tax in value in use calculations should be made only as part of its conceptual project on measurement.
- Therefore, no amendments should be made at this time to the requirement in IAS 36 to use pre-tax cash flows and pre-tax discount rates when measuring value in use.

Forward contracts arising from business combination agreements

The Board agreed that when an acquirer and vendor in a business combination agree the cost of the combination before the acquisition date (ie before the date the acquirer obtains control of the acquiree), any resulting forward contract should be excluded from the scope IAS 39 *Financial Instruments: Recognition and Measurement*.

Business Combinations (phase II)

The Board considered whether entities that present earnings per share (EPS) information should be required also to disclose an additional per share measure that includes in the numerator the effects of equity transactions with minority interests. The Board considered this issue in the light of the FASB's decision to require such a per share measure.

The Board agreed that an entity should not be required to, but also should not be precluded from, disclosing the additional per share measure.

The Board agreed to make a consequential amendment to IAS 33 *Earnings per Share* to provide that if an entity discloses, in addition to basic and diluted EPS, amounts per share that include in the numerator the effects of equity transactions with minority interests, such amounts shall be calculated using as the denominator the weighted average number of ordinary shares determined in accordance with IAS 33.

Employee Benefits

The Board's decisions in the post-employment benefits project have been taken in the context of proposals for a new format for the income statement being developed in the project on reporting comprehensive income. The publication of those proposals in an exposure draft has now been delayed. Therefore the Board considered whether and how to proceed with its decisions on post-employment benefits. The Board agreed that any short-term proposals on post-employment benefits would have to be made in the context of IAS 1 as currently drafted and asked the staff to bring a paper to the December 2003 meeting setting out the options.

[1] The field visits were conducted from early December 2002 to early April 2003, and involved Board members and staff in meetings with 41 companies in Australia, France, Germany, Japan, South Africa, Switzerland and the United Kingdom.

Financial Instruments

Improvements to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*

The Board discussed whether to include additional guidance to clarify further what contracts to buy or sell non-financial items are within the scope of IAS 32 and IAS 39.

In October 2003, the Board reconfirmed the principle set out in the exposure draft, namely that a contract to buy or sell a non-financial item is within the scope of IAS 32 and IAS 39 if the contract:

(a) can be settled net in cash or another financial instrument; and

(b) is not 'normal' (ie it does not meet the test of being entered into and continuing to be held for the purpose of receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements).

At this meeting, the Board decided to clarify that when the non-financial item that is the subject of the contract is readily convertible to cash, the contract is within the scope of IAS 32 and IAS 39 unless it is 'normal' as described above.

A written option to buy or sell a non-financial item cannot be entered into or held for the purpose of receipt or delivery in accordance with the entity's expected purchase, sale or usage requirements because it cannot ensure receipt or delivery. Accordingly, the Board agreed to clarify that if a written option to buy or sell a non-financial item is within the scope of IAS 32 and IAS 39 because its terms permit it to be settled net in cash or in another financial instrument or it is for a non-financial item that is readily convertible to cash, that written option does not qualify as 'normal'.

Improvements to IFRSs

Terminology

The Board discussed the description in some International Accounting Standards (IASs) inherited from its predecessor of optional accounting treatments as "benchmark treatment" and "allowed alternative treatment". It was noted that some have interpreted this terminology as conveying the IASC's preference for one treatment over the other, although the IASC explicitly did not do so. The objective was to identify a point of reference in making a choice between the alternatives and thereby facilitate reconciliation from national GAAP to IASs.

The Board decided to remove these references whenever possible. As part of the Improvements project, these references will be removed from IAS 16 *Property, Plant and Equipment* and IAS 31 *Interests in Joint Ventures*. The references will be removed from IAS 38 *Intangible Assets* as part of the Business Combinations project.

It was noted that IAS 31 paragraph 33 expresses a preference for the benchmark treatment. Some Board members disagreed with this preference. However, the Board agreed that the preference could not be removed without due process but also noted that this may change at a later date when the accounting for joint ventures is reconsidered.

IAS 1 *Presentation of Financial Statements*

The Board confirmed that the commitments disclosed under paragraph 101 of IAS 1 should be "contractual commitments".

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

The Board previously agreed that a change in accounting policy is applied retrospectively to the extent practicable, and a correction of an error is made by retrospective restatement to the extent practicable. At this meeting, the Board agreed that if it is impracticable to determine the cumulative effect of applying the new accounting policy to all prior periods, or if it is impracticable to determine the cumulative amount of an error made in prior periods, the entity:

(a) applies the new accounting policy or makes the corrections as far back as practicable; and

(b) disregards the portion of the cumulative catch-up entry at the beginning of the current period that is impracticable to determine.

The Board also agreed that changing an accounting policy or discontinuing an erroneous practice should not be precluded if it is impracticable to determine any cumulative catch-up entry at the beginning of the current period. In such cases, the new accounting policy should be applied prospectively from the beginning of the current period, and the erroneous practice should be discontinued from the beginning of the current period (the period in which the error is discovered).

IAS 40 *Investment Property*

The Board confirmed that entities may classify operating leases as investment property on a property-by-property basis.

The Board confirmed that entities do not have to designate an operating lease as investment property at the inception of the lease.

The Board decided that wording should be added in IAS 40 and the Basis for Conclusions to confirm its decision on the property-by-property classification alternative and that once this classification alternative is selected for one such property interest held under an operating lease, all property classified as investment property shall be accounted for using the fair value model.

Interaction of IAS 17 *Leases* and IAS 40

In July 2003, the Board decided to clarify that the fair value of a property interest held under a long-term lease, classified as an investment property asset under the fair value model in IAS 40, should be determined by reference to the rights given by the lease and that the obligation under the lease should be accounted for as a liability. The Board agreed to clarify that the interest should be valued by reference to expected cash flows–both inflows and outflows–but without deduction for any outflows that are separately recognised in the balance sheet as a liability. Accordingly, if the valuation obtained for the property is net of all payments expected to be made, it will be necessary to add back any recognised liability. A reconciliation should be provided between the valuer's net valuation and the valuation in the financial statements.

Insurance Contracts (phase I)

The Board discussed the comment letters received on ED 5 *Insurance Contracts*, with specific reference to:

- assets backing insurance contracts
- temporary exemption from the hierarchy in [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- catastrophe and equalisation provisions
- derecognition
- disclosure
- reinsurance
- loss recognition
- insurance contracts acquired in business combinations and portfolio transfers.

The Board intends to complete its discussion of the comment letters in December and to publish an IFRS by the end of March 2004.

Assets backing insurance contracts

Many commentators have asked the Board to address possible inconsistencies between the measurement of an insurer's assets and the measurement of its liabilities (described by some as a 'mismatch'). The Board began its discussion of this topic and will continue the discussion in December.

The purpose of the discussion was to identify various approaches that might mitigate the mismatch, so that the staff could research them further. The Board will consider that research, among other things, when it begins its assessment of whether it should take any action to mitigate the mismatch.

The Board directed the staff to research the following approaches:

- adjust the measurement of interest-sensitive insurance liabilities to reflect changes in interest rates that also have a corresponding effect on the fair value of fixed-maturity financial assets that are designated as backing those liabilities (and are carried at fair value and meet various restrictions to be determined).
- create a new category of fixed-maturity assets that could be reported at amortised cost—Assets Held to Back Insurance Liabilities. In discussing this approach, the Board considered a Japanese precedent (Debt Securities Earmarked for Policy Reserve - DSR).
- relax the criteria for classifying an asset as held-to-maturity and the related 'tainting provisions' in IAS 39. The tainting provisions are a way of ensuring that an entity classifies a financial asset as held-to-maturity only if the entity has a positive intent and ability to hold the asset to maturity.

The Board also directed the staff to research why some respondents stated that insurers could not classify as held to maturity a reasonably large portion of their fixed-maturity investments.

The Board did not support further staff research on the following approaches:

- extending the approaches discussed above to equity securities held to back insurance liabilities.
- limiting the approaches discussed above so that they are available only to a first-time adopter.
- establishing a new category of "available-for-settlement" liabilities (with changes in fair value recognised in equity).
- requiring an enhanced display of amounts arising from the mismatch. IFRSs already require that the amount of unrealised gains and losses on available-for-sale investments be presented as a separate item in the statement of changes in equity.
- creating a temporary exemption in phase I from some aspects of IAS 39.

The staff also intends to analyse further the following topics for the December meeting:

- the US practice known as 'shadow accounting'. Under shadow accounting, a recognised but unrealised gain or loss on an investment asset affects the measurement of insurance assets (or related deferred acquisition costs) and liabilities in the same way that a realised gain or loss does. Shadow accounting may mitigate the mismatch to some extent in some cases, but in many cases it may not mitigate the mismatch significantly.
- respondents' comments on investment property and owner-occupied property

Exemption from the hierarchy in IAS 8

ED 5 proposed a temporary exemption from paragraphs 5 and 6 of [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Board considered whether the approach in ED 5 is consistent with the approach that the Board has tentatively adopted for similar issues that arose in the project on the extractive industries. The Board directed the staff to consider this point further for the December meeting.

Catastrophe and equalisation provisions

ED 5 proposed that an insurer should not recognise as a liability any catastrophe provisions or equalisation provisions relating to possible future claims under future insurance contracts. The Board reaffirmed this proposal, and agreed to clarify that 'future insurance contracts' are contracts not in existence at the reporting date, rather than contracts that are not in existence at the date when an insurer first applies the IFRS on insurance contracts.

Derecognition

ED 5 proposed that an insurer should derecognise (ie remove from its balance sheet) an insurance liability or a portion of an insurance liability when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled, or expires. ED 5 did not address the derecognition of insurance assets. The Board reaffirmed this proposal.

Disclosure

ED 5 proposed that an insurer should disclose the fair value of its insurance liabilities and insurance assets from 31 December 2006. The Board agreed to delete this proposal.

The disclosure requirements proposed in ED 5 are designed as two high level principles, supplemented by some specified disclosures to meet those objectives. Draft Implementation Guidance discusses how an insurer might satisfy the requirements. The Board agreed to retain that approach.

The Board agreed to clarify the status of the Implementation Guidance on disclosure, stating that an insurer would decide in the light of its circumstances how much detail it would give to satisfy the disclosure requirements in the IFRS, how much emphasis it would place on different aspects of the requirements and how it would aggregate information to display the overall picture without combining information that has materially different characteristics. To satisfy the requirements, an insurer would not typically need to disclose all the information suggested in the guidance. The implementation guidance does not create additional requirements.

The Board will discuss the content of the disclosure requirements and related Implementation Guidance in December. At that meeting, the Board will also consider whether any material now in the Implementation Guidance should be transferred to the IFRS and made mandatory.

Reinsurance

Paragraph 10(d) of ED 5 prohibits offsetting of reinsurance assets against reinsurance liabilities and of income or expense from reinsurance contracts against expense and income from the related insurance contracts. The Board reaffirmed that proposal.

Paragraph 18 of ED 5 proposed to limit the reporting of gains when an insurer buys reinsurance for insurance liabilities that are measured on an undiscounted basis or with excessive prudence. The gains arise because reinsurance premiums are likely to reflect the time value of money and a realistic assessment of the cash flows.

In the light of the comment letters, the Board concluded that the proposals in ED 5 would potentially require systems changes only for phase I because it would capture too many transactions that were not the main target of the proposals. The Board concluded that it would be impracticable to develop more targeted proposals. Accordingly, the Board decided to replace paragraph 18 with a requirement for a cedant to disclose the extent to which profit or loss includes gains that arose at the inception of reinsurance contracts, including those that are being recognised over more than one period. The Board also directed the staff to research whether cases exist in which it is impracticable to determine the amount of some of those gains. If such cases exist, the cedant would be required to disclose that fact and the amount of those gains that it can determine practicably.

Paragraph 19 of ED 5 confirms that a cedant applies IAS 36 *Impairment of Assets* to its rights under a reinsurance contract. However, this would, in effect, compel many cedants to change their accounting model for reinsurance contracts in a way that is inconsistent with the accounting for the underlying direct insurance liability. The Board decided that this is beyond the scope of phase I and agreed to replace paragraph 19 of ED 5 with a paragraph indicating that, based on the impairment test in IAS 39, if a cedant's rights under a reinsurance contract are impaired, the cedant shall reduce their carrying amount accordingly. Those rights are impaired if and only if there is objective evidence as a result of an event that occurred after initial recognition of the rights that the cedant may not receive all amounts due to it under the terms of the contract, and that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

The Board will consider two other issues relating to reinsurance contracts in December: the definitions of insurance contracts and reinsurance contracts and unbundling.

Loss recognition

The Board discussed the loss recognition proposals in paragraphs 11-13 of ED 5. As explained in paragraph BC64 of the Basis for Conclusions for ED 5, the purpose of the loss recognition test in ED 5 is not to superimpose on an insurer's existing model piecemeal elements of a parallel measurement model, but to create a mechanism that reduces the possibility that material losses are unrecognised during phase I.

The Board confirmed that:

- If an insurer's loss recognition test meets the minimum requirements specified in paragraph 11 of ED 5, the test is carried out at the level of aggregation specified in that test.
- If insurer's loss recognition test does not meet those minimum requirements so that it uses IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as the loss recognition test, the comparison of carrying amounts with the amounts determined in accordance with IAS 37 is made at the level of a portfolio of contracts that are subject to similar risks and managed together as a single portfolio.

The Board agreed not to add further guidance on cash flows and discount rates.

Some respondents to ED 5 suggested that the inclusion of embedded options and guarantees in the cash flows used for a loss recognition test could permit the Board to exempt some embedded derivatives from fair value measurement under IAS 39. The Board will consider that suggestion in December.

The Board directed the staff to consider whether the proposed disclosures are sufficiently rigorous, given the lack of detailed requirements for the loss recognition test.

Insurance contracts acquired in business combinations and portfolio transfers

IAS 22 *Business Combinations* requires an entity to measure at fair value assets acquired and liabilities assumed in a business combination and ED 3 *Business Combinations* proposes to continue that long-standing requirement. ED 5 would not exclude insurance liabilities and insurance assets (and related reinsurance) from that requirement. However, ED 5 would permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues.
- an intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value.

The expanded presentation would also be available for a block of insurance contracts acquired in a portfolio transfer.

The Board reaffirmed the proposals in ED 5 on insurance contracts acquired in business combinations and portfolio transfers.

Paragraph 20 of ED 5 states that it applies only to contractual rights and contractual rights and obligations. The Board will consider in December how this proposal interacts with proposals in ED 3 *Business Combinations* on contractual rights from related customer relationships.

Insurance Contracts (phase II)

Phase II has been more or less dormant since January 2003. A small team of Board members and the project staff has carried out a review to assess how the Board should reactivate phase II. The Board discussed the team's findings and agreed the following.

- Phase II should continue to be a high priority project
- On restarting the project the Board should return to a study of the basics. To this end:
    - A reference source should be developed which compares and contrasts the fair value model with other insurance accounting models. The document would initially be compiled from materials developed by the IASC Steering Committee and by staff during the course of the project. It would then be added to over time.
    - A block of Board time should be allocated when the project recommences to provide an opportunity for reconsideration of the basic issues in depth.
- Roundtable discussions and field visits should be conducted during the exposure draft phase. The Board is not convinced that the additional benefit that may be obtained from conducting field tests rather than field visits would outweigh the additional costs.
- Specialised task forces should be established to assist staff.

- The Insurance Advisory Committee should be retained, with a revised role of providing a forum for staff to discuss higher-level issues and a convenient means of obtaining feedback on progress.
- A working group of staff experts from national standard-setters should be established to assist staff.
- Selected industry participants should make presentations to the Board on issues that prove problematic.
- The project should be restarted in May 2004.
- The Board should aim to complete an exposure draft by June 2005.
- The Board should encourage "non insurance" parties (for example, accounting firms' IFRS desks, the academic community, securities regulators, users) to become more actively involved in the project.

Leases

To advance the Leasing research project, the Board discussed the foundations of a conceptual model for analysing the assets and liabilities that arise from lease contracts. The Board tentatively agreed with the proposed approach of analysing the contractual rights and obligations arising from lease contracts. It was noted that this approach is consistent with that being explored in the Revenue Recognition project.

The Board expressed a preference for considering lessor accounting early in the project. This would include determining when it is appropriate for lessors to derecognise leased assets and recognise revenue. It would also involve consideration of the nature of the assets that should be recognised by lessors (including whether the physical asset should continue to be recognised).

The Board tentatively agreed that recognising the assets and liabilities arising in respect of all leases should provide more relevant, reliable and comparable financial information. Rather than focusing on whether a lease conveys rights similar to outright ownership, the Board tentatively agreed that the conceptual model should consider the conveyance of rights to future economic benefits.

The Board tentatively agreed that in many cases delivery of the leased asset is the appropriate point for recognition of assets and liabilities arising under leases. However, in order to make the model broadly applicable, the Board noted that further consideration would need to be given to more complex scenarios to determine exactly what rights are being conveyed to the lessee and the point at which the entity controls those rights and, thus, when recognition is appropriate. For example, the draft IFRIC interpretation *Determining Whether an Arrangement Contains a Lease* would result in some supply arrangements (such as take-or-pay contracts) being classified as leases, even though the underlying physical property is not delivered to the purchaser.

The Board tentatively agreed that the assets and liabilities that arise from contractual rights and obligations under a lease should reflect the conveyance of the right of use and control of associated future economic benefits for the period of the contract, rather than conveyance of the whole of the physical property.

The Board considered the assets and liabilities that would be recognised under the proposed model by considering some simple examples. The Board tentatively agreed that if a lease contract is freely cancellable by the lessee, the asset and liability amounts recognised by the lessor and the lessee should reflect both (i) the conveyance of the right of use up to the date at which the lease can be cancelled by the lessee and (ii) the lessee's option in respect of periods beyond that date. The Board tentatively agreed that if a lease contract is freely cancellable by the lessor, the asset and liability amounts recognised by the lessor and the lessee should reflect both (i) the conveyance of the right of use up to the date at which the lease can be cancelled by the lessor and (ii) the lessor's option in respect of periods beyond that date. It was assumed for the purposes of the discussion that the options have economic substance.

The Board noted that consideration would need to be given to the decisions being made in other projects (such as Revenue Recognition) as the Leasing project advances, to ensure consistency.

Reporting Comprehensive Income

The Board agreed to publish a discussion paper on its Reporting Comprehensive Income project. The purpose of the discussion paper would be to consult widely, to inform and educate, and to explain (where applicable) the provisional decisions that the Board has reached. The discussion paper should encompass the numerous viewpoints on the subject of reporting comprehensive income, including those expressed during field visits, and explain the Board's thinking with respect to these viewpoints.

The Board approved a broad outline structure for the discussion paper as proposed by staff. A more detailed proposal for a discussion paper will be discussed at a future meeting.

The Board noted that a joint working group with the FASB had been agreed but had not yet met.

Share-based Payment

The Board continued its discussions of accounting for the tax effects of share-based payment transactions. At the October 2003 tripartite meeting of the IASB, FASB and Canadian AcSB, the IASB and FASB tentatively agreed that, for a tax deduction relating to an equity-settled transaction (eg a transaction in which shares or share options are granted to employees), the tax effects relate to both an income statement item and an equity item. At this meeting, the Board considered various methods to allocate the tax effects between the income statement and equity, and other related issues, including the measurement of the deferred tax asset. The Board tentatively agreed:

- The measurement of the deferred tax asset each period should be based on an estimate of the future tax deduction (if any). If changes in the share price affect the amount of the future tax deduction, the estimated tax deduction should be based on the current share price.
- The deferred tax asset recognised (if any) should be based on the expected future tax benefits relating to both the income statement item and the equity item.
- The expected future tax benefits (and, ultimately, the tax benefits actually received), if any, should be allocated between the income statement and equity on the following basis:
  - (a) If the estimated (or actual) tax deduction is less than, or equal to, the cumulative recognised compensation expense, the associated tax benefits are recognised in profit or loss.
  - (b) If the estimated (or actual) tax deduction exceeds the cumulative recognised compensation expense, the excess associated tax benefits are recognised directly in equity.

- In the cash flow statement, the tax cash flows should be classified in a manner that is consistent with the recognition of the tax benefits in the income statement and equity. Therefore, any tax benefits recognised in the income statement should be classified in the cash flow statement as operating cash inflows. Any tax benefits recognised directly in equity should be classified as financing cash inflows.
- For the purpose of earnings for share calculations, the tax benefits that would be credited directly to equity should be included in the calculation of the assumed issue proceeds.
- For a cash-settled transaction (eg a transaction in which cash share appreciation rights are granted to employees), the measurement of the deferred tax asset should be based on an estimate of the future tax deduction (if any). If changes in the share price affect the amount of the future tax deduction, the estimated tax deduction should be based on the current share price. All tax benefits received, or expected to be received, should be recognised in the income statement.

Meeting dates: 2003-2004

The Board will next meet in public session on the following dates. Meetings take place in London, UK, unless otherwise noted.

2003

17—19 December

2004

21—23 January

18—20; 23, 24 February†

17—19 March

21—23; 26,27 April‡

19—21 May

21—25 June, Oslo, Norway†

21—23 July

22—24; 27, 28 September‡

20—22 October, Norwalk, Connecticut, USA

15—19 November†

15—17 December

† Includes a meeting with the Standards Advisory Council

‡ Includes meetings with partner standard-setters