BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

June 2002

The International Accounting Standards Board met in technical session in Berlin, Germany, 17-19 June 2002, when it discussed:

- Business combinations (phase II)
- Convergence of accounting standards
- Insurance contracts
- Reporting performance
- Share-based payment.

The IASB met the Standards Advisory Council in Berlin, on 20 and 21 June. They discussed:

- Business combinations
- Consolidation and special purpose entities
- Candidate topics or projects for convergence of accounting standards
- Insurance contracts
- Proposed IASB agenda topics
- Reporting performance
- Share-based payment.

A full report of the meeting will be included in the next issue of *IASB Insight*.

Business combinations (phase II)

At its meeting in April 2002 meeting the Board agreed that, in a business acquisition, contingent assets and contingent liabilities should be recognised at fair value. The Board also asked the staff to explore replacing the definitions of contingent asset and contingent liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with the following definitions:

> A *contingent asset* is a present right that arises from past events that may result in a future cash inflow (or other economic benefits) based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
>
> A *contingent liability* is a present obligation that arises from past events that may require a future cash outflow (or other sacrifice of economic benefits) based on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

The purpose of so doing is to make it clear that there is no difference in contingent assets and contingent liabilities in accounting for business combinations under US generally accepted accounting principles and under IFRSs. The purpose is not to change the recognition rules of IAS 37 for contingent assets and contingent liabilities arising other than in a business combination.

The Board considered a draft amendment to IAS 37 designed to achieve this objective. The Board agreed to proceed with such an amendment and noted that the draft could be improved by a clearer explanation that liabilities, provisions and contingent liabilities (as newly defined) are all recognised if the outflow of economic resources is probable.

Recognition and measurement issues related to acquired assets and assumed liabilities in a business combination

The Board considered adopting additional fair value measurement guidance to ensure the consistent application of the fair value working principle in the measurement of acquired assets and assumed liabilities. The Board agreed to adopt the following framework (hierarchy) for that purpose:

> The measurement of identifiable assets and liabilities initially recorded at fair value by the acquirer in a business combination should be determined as follows:
>
> (1) By reference to an observable market transaction (for example, an exchange of cash for the same or similar item at or near the transaction date).
>
> (2) if (1) is not available, through estimation techniques (such as present value, option pricing models, or appraisals) using market-based assumptions with the objective of determining the item's fair value. Market-based assumptions are assumptions that market participants would consider in assessing the fair value of an asset or a liability when the fair value cannot be directly observed in the market.
>
> (3) if neither (1) nor (2) is available, through estimation techniques (such as present value, option pricing models, or appraisals) using assumptions not contrary to market assumptions (in instances where market-based assumptions are not available, as a practical matter, an entity can use its own assumptions). Assumptions are not contrary to market assumptions (that is, they are compatible with the fair value measurement objective) as long as there is no contrary information indicating that market participants would use different assumptions. If such information is available, assumptions that incorporate market information should be used.

The Board noted that at later meetings, the staff would address specific application issues that arise in applying the fair value measurement hierarchy.

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Convergence

The Board considered an initial analysis of the requirements of IFRSs and those of standards issued by their liaison standard-setters. The analysis will be extended to cover other IFRSs (except those addressed by other IASB projects) and these will be discussed at the meeting in July 2002. The Board made the following observations:

IAS 2 *Inventories* and IAS 10 *Events after the Balance Sheet Date*: no convergence work needed.

IAS 12 *Income Taxes* was a candidate for convergence, but the scope should be limited to the application of the temporary difference approach. If this convergence work raised questions about the basic approach to accounting for income taxes, that project would have to be considered as a major project in its own right, rather than as a convergence project.

IAS 14 *Segment Reporting* was an area where convergence should be considered. It was agreed to ask financial analysts for input about the usefulness of the current North American approach compared with the predecessor FASB standard (which was similar to the current IAS 14).

IAS 23 *Borrowing Costs*: it was agreed that this should be considered in light of the active research project on measurement being undertaken by the Canadian Accounting Standards Board.

IAS 28 *Accounting for Investments in Associates*: it was agreed that this should be considered together with IAS 31 *Accounting for Joint Ventures* and that a paper should be prepared for the national standard-setters meeting in October 2002 exploring the possibility of conforming the definition of joint ventures and eliminating the use of the proportionate consolidation method.

IAS 35 *Discontinuing Operations*: it was agreed that convergence work should begin on this topic, although issues related to impairment should be excluded and addressed in the Canadian measurement research project mentioned above.

The Board then considered a proposed scope and project plan for a convergence project on IAS 19 *Employee Benefits*. The scope and project plan were agreed, with the addition of a review of FAS 112 *Employers' Accounting for Postemployment Benefits* and FAS 106 *Employers' Accounting for Postretirement Benefits Other Than Pensions* to consider whether additional guidance in these standards should be included in IAS 19. It was noted that any significant amendment to IAS 19 should be linked to the project on performance reporting.

Insurance contracts

The Board discussed insurance contracts that the policyholder can cancel before the end of their term. The future cash flows under such contracts can be divided into:

(i) cash flows that will arise even if the policyholder exercises the option to cancel the contract; and

(ii) additional cash flows that will arise only if the policyholder does not cancel the contract.

The entity-specific value or fair value of an insurance contract includes the expected present value (probability-weighted and risk-adjusted) of the first set of cash flows. However, some think that it is less clear whether entity-specific value or fair value also includes the expected present value of the additional cash flows. In some cases, their inclusion would increase the reported liability, and this would be broadly consistent with the recognition and measurement of onerous contracts under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Therefore, the Board's discussion focused mainly on cases in which the inclusion of additional cash flows would reduce the recognised liability or create a reported asset. Some Board Members argued that cash inflows from future premiums do not meet the definition of an asset. Some questioned whether the inclusion of the additional cash flows would result in the implicit recognition of an intangible asset not qualifying in other contexts for recognition under IAS 38 *Intangible Assets*.

Other Board members maintained that the measurement of the book of insurance contracts should reflect all cash flows associated with the contract, including the additional cash flows. They noted that:

- the price negotiated for a transfer of the contractual rights and obligations to another insurer would reflect those additional cash flows; and
- because the insurer would not have access to the additional cash flows if it did not have the rights and obligations that gave rise to the first set of cash flows, it is appropriate to consider both sets of cash flows together.

Some Board Members expressed concerns about the possible implications of applying the proposed insurance accounting model to commercial and financial contracts. A number also questioned whether the proposed criteria (below) in effect limited the application of the accounting model.

The above discussion refers to cancellation options, but an option to cancel can equally be viewed as policyholders holding an option to renew the contract. It is proposed that the measurement of insurance contracts should include the additional cash flows 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 because the options significantly constrain the insurer's ability to reprice the contract at rates that would apply to new policyholders who have characteristics similar to the holder of the option.

The Board plans further discussion on the following topics before reaching a conclusion:

- the measurement objective for insurance contracts (in other words, whether they should be measured at entity-specific value, fair value or on some other basis);
- the implications of the proposed approach for other long-term contracts such as investment management contracts, bank core deposits, credit card receivables, pre-payable mortgages, mortgage servicing rights, construction contracts, long-term supply contracts and customer loyalty programmes;
- the criteria used to determine when it is appropriate to include the additional cash flows;
- the implications of this approach for the recognition of gains at the inception of an insurance contract; and
- if the expected present value (probability-weighted and risk-adjusted) of the additional cash flows results in a debit, whether an insurer should report that amount as a separate asset or as a reduction of the liability.

Reporting performance

The Board continued its discussion of a staff concepts paper on reporting performance. This is a joint project with the UK Accounting Standards Board.

The Board discussed the reporting of financial instruments, as recognised and measured under IAS 39 *Financial Instruments: Recognition and Measurement*. Specifically, the Board considered which income and expenses relating to financial instruments should be classified as remeasurements, to be reported separately in the second column of the proposed performance statement.

For financial assets and liabilities measured at amortised cost, the Board tentatively agreed that impairments should be reported in the column of the proposed performance statement that reports estimate changes related to future periods ('Column 2') and that interest income and expense determined in accordance with IAS 39 should be reported in the column of the proposed performance statement that reports all other items ('Column 1').

For financial assets classified as available for sale, the Board tentatively agreed that interest income and expense determined in accordance with IAS 39 should be reported in Column 1. All other income and expenses, which would include those arising as a result of impairments, disposals/settlements and remeasurements to fair value, should be reported in Column 2. The Board tentatively decided that the question of determining and reporting fair value interest should be dealt with in a future project on financial instruments.

For financial assets and liabilities classified as held for trading, the Board tentatively agreed that all changes in the fair value of such assets and liabilities should be reported in Column 2. Board Members expressed concern about the consistency of this decision with earlier decisions about other assets and liabilities and asked the staff to consider further the implications of its decisions on financial assets and liabilities.

For fair value hedges, the Board tentatively agreed that income or expense arising on the hedging instrument and on the hedged item should be reported together, in the performance statement category of the hedged item. The Board also discussed cash flow hedges, without reaching a conclusion. The staff were asked to return to the subject of cash flow hedges at the next meeting.

Share-based payment

The Board continued its discussion of the valuation of share options. First, the Board discussed whether unlisted (private) companies should be required to measure share options at fair value, or whether they should be permitted to use the minimum value method instead. After receiving further advice on this issue from the project's Advisory Group, the Board tentatively agreed that there should be no exceptions to the fair value measurement method, and that the IFRS should provide guidance on estimating expected volatility for the purposes of applying an option pricing model to options granted by unlisted companies.

The Board also continued its discussions of the valuation impact of vesting conditions, discussed previously at its meetings in April and May 2002. The Board tentatively agreed that the valuation of the rights to options or shares granted should take into account all types of vesting conditions, including service conditions and performance conditions. In other words, the grant date valuation should be reduced to allow for the possibility of forfeiture because of failure to satisfy vesting conditions. The resulting valuation then should be applied to the services received. The Board also tentatively agreed that the entity should be required to disclose the assumptions made in determining grant date valuation with regard to the possibility of forfeiture, and also required to disclose information on actual forfeitures compared with expected forfeitures estimated at grant date.

The Board considered a worked example of how its tentative conclusion on repricing of options, discussed at its meeting in May 2002, would be incorporated into its proposed treatment of vesting conditions. The Board tentatively agreed to an approach that would treat the repricing of options as, in effect, a new option grant, measured at the incremental value granted. Therefore, an expense would be recognised in respect of the original option grant when services are received during the original vesting period, and additional remuneration expense would be recognised in respect of the new option grant when services are received during the new vesting period. However, the Board also tentatively agreed that the Exposure Draft should set out an alternative approach, which would combine the remaining remuneration expense in respect of the original option grant as at the date of repricing with the additional remuneration expense in respect of the repriced options, and recognise this total over the vesting period of the repriced options. Comments on both approaches would be requested.

The Board also discussed other accounting and measurement issues. The Board tentatively agreed that no gain should be recognised for options that lapse at the end of the exercise period. Therefore, no accounting entry is required (apart from possibly a movement within equity, ie a transfer from one part of equity to another, if the options were previously disclosed separately).

The Board discussed the accounting treatment of share appreciation rights (SARs) settled in cash and tentatively agreed that:

- a liability should be accrued over the vesting period, when services are provided by the employees (or other parties).
- a liability should be measured at fair value.
- there should be separate disclosure, either on the face of the income statement or in the notes, of that portion of the expense recognised during each accounting period that is attributable to changes in the estimated fair value of the liability between grant date and settlement date.

The Board also discussed share plans with cash alternatives, and tentatively agreed that:

(a) for share plans where the *employee* has the choice of settlement:

- the compound financial instrument should be separated into its debt and equity components.
- the fair value of the compound instrument should be estimated at grant date, by first estimating the fair value of the liability component, then estimating the fair value of the equity component—taking into account that the employee must forfeit the cash alternative to receive the option—and summing the two component values.
- both components should be recognised over the vesting period, in the same manner as other forms of share-based payment, except that the debt component should be remeasured to fair value at each balance sheet date; the equity component should not be remeasured.
- at the time of settlement, any difference between the amount of the liability component previously recognised and the amount of cash paid or the fair value of the liability component at the date it is surrendered should

be accounted for as an adjustment to the transaction amount, that is, as an adjustment to the expense.

- settlement should be accounted for as follows:
  - if the employee chooses the cash alternative, the cash payment will settle the liability in full. The amount of the equity component (if any) that was recognised previously should remain in equity, as it represents the equity component of the compound instrument that has been surrendered by the employee.
  - if the employee does not elect to receive the cash alternative, the amount of the liability component of the compound instrument that previously was recognised as a liability should be transferred directly to equity.
- there should be separate disclosure, either on the face of the income statement or in the notes, of that portion of the expense recognised during each accounting period that is attributable to changes in the estimated fair value of the liability between grant date and settlement date.

(b) for share plans that give the *entity* the choice of paying cash or issuing equity instruments:

- if a liability exists (for example, the choice is not a substantive choice or a constructive obligation to settle in cash exists), the same accounting treatment as for cash-settled SARs should be applied.
- if no liability exists, the transaction should be accounted for in the same manner as other forms of equity-settled share-based payment transactions.
- if the entity elects to settle in cash rather than issue equity instruments, the cash payment should be debited to equity as the repurchase of an equity interest, except as noted below.
- if the entity elects to settle by issuing equity instruments, no accounting entry is required (other than a movement within equity, if the various types of equity interests are disclosed separately), except as noted below.
- if the entity chooses the settlement alternative with the higher fair value, as estimated at the date of settlement, additional remuneration expense should be recognised for the excess value given, ie the difference between the cash paid (or fair value of the equity instruments issued) and the fair value of the equity instruments that otherwise would have been issued (or the amount of cash that otherwise would have been paid).
- similarly, for share plans that allow the entity to pay cash to employees rather than issue shares upon the exercise of share options, the cash payment should be treated as the repurchase of an equity instrument and debited to equity. However, if the cash paid exceeds the gain that the employee would realise on exercise of the option, additional remuneration expense should be recognised for that excess cash paid.

The Board agreed to seek further advice from the project's Advisory Group on the valuation implications of the entity having a choice of settlement.

The Board also tentatively agreed that equity instruments transferred directly from shareholders to employees, or to other parties who have provided goods or services to the entity, should be accounted for as share-based payment transactions, unless the transfer clearly is for a purpose other than compensation for goods or services supplied to the entity.

Meeting dates: July – December 2002

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

17 – 19 July

18 – 20 September, Norwalk, Connecticut, USA

23 – 29 October‡

12 – 16 November, Hong Kong SAR, China†

18 – 20 December

† Includes a meeting with the Standards Advisory Council

‡ Includes a meeting with partner national standard-setters