BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

November 2002

The International Accounting Standards Board met in Hong Kong SAR on 12-14 November 2002, when it discussed:

- Business combinations (phase II)
- Convergence of accounting standards
- Employee benefits
- Improvements to existing standards
- Insurance contracts (phase I)
- Liabilities and equity
- Revenue recognition

The IASB met the Standards Advisory Council in Hong Kong on 15 and 16 November 2002. The meeting discussed:

- Convergence of accounting standards
- Insurance
- Measurement
- Regulatory developments in the EU
- Reporting performance
- Research projects
- Revenue and liabilities
- Share-based payment

A full report of the meeting's discussions will be included in a forthcoming issue of *IASB Insight*.

Business combinations (phase II)

Issues related to minority interests

The Board considered the following two threshold issues related to minority interests:

- Recognition of goodwill in the acquisition of less than a 100 per cent interest in an entity
- Nature and classification of minority interests in a consolidated balance sheet.

Recognition of goodwill in the acquisition of less than a 100 per cent interest in an entity

The Board agreed that the full goodwill method should be used to recognise goodwill in the acquisition of less than a 100 per cent controlling interest in the acquired entity. Under the full goodwill method, all of the goodwill of the acquired entity, not just the acquirer's share, is recognised. Goodwill is measured as the difference between the fair value of the acquired entity as a whole and the fair values of all of its identifiable assets acquired and liabilities assumed at the date control is obtained.

The Board also agreed that whichever side of the transaction provides clearer evidence—the consideration paid to acquire the controlling interest (assuming the control premium can be measured reliably) or the fair value of the acquired entity—should be used to measure the fair value of the acquired entity as a whole. The direct measurement of the fair value of the acquired entity as a whole could be performed using, for example, an appraisal or some other valuation technique. The approach based on inferring the fair value of an acquired entity as a whole from the price paid could be used only in those circumstances in which a control premium is clearly identifiable and measurable with sufficient reliability.

The Board directed the staff to explore whether implementation guidance is necessary in circumstances in which the fair value of the acquired entity as a whole is measured directly. The objective of such guidance would be to address any measurement difficulties arising from a direct measurement of the fair value of the acquired entity (for example, whether the fair value of the expected synergies and other benefits from combining the acquiree's net assets with those of the acquirer should enter into measurement of the fair value).

The Board also directed the staff to explore whether the Board should reconsider the treatment of the acquiree's assets that did not satisfy the criteria for recognition separately from goodwill at the time of initial accounting for the business combination when such assets subsequently satisfy those criteria because of events taking place after the acquisition date.

Nature and classification of minority interests in a consolidated balance sheet

The Board agreed that minority interests in the net assets of consolidated subsidiaries should be identified and presented in the consolidated balance sheet within equity separately from the parent shareholders' equity. This decision affirms a tentative conclusion that the Board proposed and exposed for comment in its May 2002 Exposure Draft of proposed *Improvements to International Accounting Standards.*

The Board noted that it would consider the following minority interest issues at its later meetings:

- Step acquisitions—fair value measurement of an acquired entity and the measurement of goodwill in a business combination achieved in more than one stage that results in obtaining control
- The accounting for subsequent increases in ownership of a subsidiary by members of the consolidated group after control has been obtained
- Display of minority interests in the consolidated income statement or statement of changes in shareholders' equity
- Accounting for subsequent decreases in ownership of a subsidiary by members of the consolidated group that do not result in a loss of control
- Accounting for subsequent decreases in ownership of a subsidiary by members of the consolidated group that result in a loss of control.

(continued…)

Copyright © IASB Update is published immediately after every IASB meeting by the International Accounting Standards Board,
30 Cannon Street,
London EC4M 6XH, United Kingdom
E-mail: iasb@iasb.org.uk
Internet: www.iasb.org.uk

IASB Publications Department,
30 Cannon Street, London, EC4M 6XH
United Kingdom
Tel: +44 (0)20 7332 2730
Fax: +44 (0)20 7332 2749
E-mail: publications@iasb.org.uk
ISSN 1474-2675

Business combinations (phase II) (continued)

Contingent assets that are financial instruments not within the scope of IAS 39

In April 2002, the Board considered the treatment of contingent assets acquired and contingent liabilities assumed in a business combination. The Board's decision on the subsequent accounting for the acquiree's contingent assets acquired and contingent liabilities assumed covered contingent liabilities of the acquiree that are financial instruments explicitly excluded from the scope of IAS 39. Under the Board's decision such contingent liabilities should be subsequently remeasured at fair value. However, at that time the Board did not consider the subsequent accounting for the acquiree's contingent assets that are financial instruments explicitly excluded from the scope of IAS 39.

In November 2002, the Board considered the subsequent accounting for such contingent assets and agreed to require that recognised contingent assets of the acquiree that are financial instruments excluded from the scope of IAS 39 be remeasured at fair value after the business combination.

Comparison of IASB and FASB conclusions in phases I and II

The Board considered a paper that has been prepared in response to the Boards' request at the joint September meeting with respect to differences between the Boards' conclusions in the Purchase Method Application project. The paper:

(a) illustrates the differences that arise because the Boards diverged in their conclusions in the joint Purchase Method Application project.

(b) identifies the broad areas that need to be comprehensively addressed outside of the Business Combinations project for 'inherited' differences and indicates which of those differences would be addressed in the joint short-term convergence project.

The Board noted that illustration (a) would be updated on an ongoing basis throughout the remainder of the project to help the Boards assess the implications of those conclusions on which the Boards tentatively have diverged in the joint project. The Board also noted that group (a) includes some issues for which there may be opportunities to eliminate differences before the exposure drafts resulting from phase II are issued.

Convergence

Joint short-term project with the FASB:
IAS 35 *Discontinuing Operations*

The Board considered issues relating to the possible convergence of IAS 35 *Discontinuing Operations* with the presentation requirements for discontinuing operations in FAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Board agreed that the presentation requirements of IAS 35 should be amended to follow FAS 144 as closely as possible. It was agreed that the resulting revision of IAS 35 should take the form of a new IFRS, rather than an amendment to IAS 35. It was also agreed that the staff would prepare for the next Board meeting a paper on the implications of this decision for the timing of provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Post-employment benefits

Consolidation and balance sheet presentation issues

The Board discussed whether defined benefit plans should be consolidated, what assets and liabilities arise from an entity's participation in a defined benefit plan and how they should be presented in the balance sheet. The Board agreed that the question of whether and when defined benefit plans should be consolidated was too big an issue for this limited convergence project and should instead be addressed in the Consolidations project. In the meantime, the Board agreed that the objective of IAS 19 *Employee Benefits* should be the recognition and measurement of the asset or liability that arises from the entity's interest in the plan. Following from this objective, the entity should recognise an asset representing the entity's rights over the use of the surplus (being the net asset in the defined benefit plan subject to the asset ceiling) or a liability representing its obligation to fund the deficit (being the net liability in the defined benefit plan).

Possible guidance on the asset ceiling

At the September 2002 meeting, the Board considered whether there should be a limit on the amount that can be recognised as an asset in respect of a surplus in a defined benefit plan. It agreed that the principle to be followed was that the entity should recognise as an asset the rights the entity has to benefit from the surplus. In measuring those rights, the following hierarchy should be followed:

(a) value the entity's rights to refunds and reductions in future contributions. If this is less than the surplus, then

(b) value the entity's rights to fund increased benefits to current and future employees. No value should be ascribed to the entity's right to fund increased benefits to past employees.

If (a) and (b) together are less than the surplus, then

(c) value the entity's right not to fund future losses in the plan to the extent that the losses will be absorbed by the surplus.

The Board considered whether guidance was needed on how to apply the hierarchy. It agreed that guidance was needed, but that it should not form part of the standard. The Board agreed the following:

The entity's rights to refunds and reductions in future contributions

(a) the entity should determine the expected value of rights to refunds and reductions in future contributions

(b) the expected value of the entity's rights to reductions in future contributions should be calculated as:
   - (i) the present value of the liability expected to arise from future service by current and future plan members, *less both*:
   - (ii) the present value of future employee contributions that would be expected if there were no surplus and
   - (iii) the present value of the minimum contributions that the entity is required to make despite the existence of the surplus.

(c) in measuring items b(i) and (ii):
   - (i) the actuarial assumptions should be the same as those used to measure the defined benefit obligation, ie the best estimate.

(ii) the benefits promised under the plan should be assumed to be the same as those reflected in the measurement of the defined benefit obligation.

(iii) the assumptions about the size and demographic nature of the workforce should be consistent with management's budgets/forecasts. Beyond the period covered by the budgets/forecasts, the workforce should be assumed to be steady unless there is external evidence to support different assumptions.

(d) in measuring item b(iii), where the measurement basis underlying a requirement for the entity to make contributions is legally prescribed, the required contributions to be deducted in arriving at the asset should be based on that legally prescribed measurement basis.

(e) in measuring items b(i), (ii) and (ii), the discount rate should be the same as that required by IAS 19 for the defined benefit obligation, without any adjustment for the uncertainty relating to reductions in future contributions.

The entity's rights to fund increased benefits to current and future employees

(f) in determining the value of the entity's rights to fund increased benefits to current and future employees:

(i) IAS 19 should note that plan trustees might require increases in benefits to past members as well as current members and/or additional contributions to be made to the plan to cover such increases. Such requirements would affect the amount of the surplus that the entity had the right to use to give benefits to current (and future) members.

(ii) as agreed at the September meeting, no asset should be recognised in respect of the entity's ability to fund increases in benefits to past employees.

(iii) the assumptions about the future size of the workforce should be consistent with those recommended in determining the value of the reductions in future contributions (see (c)ii above).

The staff noted that possible guidance on level (c) of the hierarchy (ie how to value an entity's rights not to fund future losses in the plan to the extent that they are absorbed by the surplus) would be brought to a later Board meeting, after the staff had consulted actuaries on the matter.

Improvements to existing IFRSs

The Board considered comments received on its exposure draft (ED) of proposed *Improvements to International Accounting Standards*. The comment period ended on 16 September 2002 and over 150 submissions were received. Apart from responding to the specific questions in the Invitation to Comment, commentators also raised issues on other changes proposed or on other aspects of the revised standards.

At this meeting, the Board considered comments received on the following five of the twelve standards addressed in the ED.

IAS 1 *Presentation of Financial Statements*

The Board considered comments on the following six questions asked in the Invitation to Comment on the proposed revisions to IAS 1.

> Question 1
>
> *Do you agree with the proposed approach regarding departure from a requirement of an International Financial Reporting Standard or an Interpretation of an International Financial Reporting Standard to achieve a fair presentation?*

The Board confirmed the approach proposed in paragraphs 13-16 of the ED.

The Board confirmed that the financial statements of an entity that departed from the requirement in the manner set out in paragraph 14 of the ED and those of an entity that followed the approach set out in paragraph 15 because the relevant regulatory framework prohibits a departure from a requirement in a standard, would both be described as in accordance with IFRSs. But those financial statements would be described as in accordance with IFRSs only in the extremely rare circumstances, when it was necessary for management to depart from a requirement in an IFRS or an Interpretation of an IFRS in order to meet the objectives of financial statements set out in the *Framework*.

The Board decided to include in the revised standard the text of paragraph 12 of the current version of IAS 1, which was deleted in the ED.

The Board decided to clarify in the revised standard that management should disclose the impact of a departure from a requirement from an IFRS or an Interpretation of an IFRS for all periods presented.

> Question 2
>
> *Do you agree with prohibiting the presentation of items of income and expense as 'extraordinary items' in the income statement and the notes?*

The Board confirmed its decision to prohibit the presentation of items of income and expense as 'extraordinary items' in the income statement and the notes. The Board decided to delete proposed paragraph 79 and to clarify in the Basis for Conclusions the impact of the deletion of extraordinary items on the presentation of the income statement.

> Question 3
>
> *Do you agree that a long-term financial liability due to be settled within twelve months of the balance sheet date should be classified as a current liability, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the balance sheet date and before the financial statements are authorised for issue?*

The Board confirmed its proposal that a long-term financial liability due to be settled within 12 months of the balance sheet date should be classified as current at the balance sheet date, if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the balance sheet date and before the financial statements are authorised for issue. This treatment is in accordance with the definition of non-adjusting events after the balance sheet date in IAS 10 *Events After the Balance Sheet Date*.

> Question 4
>
> *Do you agree that:*
>
> *(a) a long-term financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the balance sheet date, even if the lender has agreed after the balance sheet date, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach?*

The Board confirmed its proposal to classify such a long-term financial liability as current at the balance sheet date in accordance with the principles in IAS 10.

> Question 4
>
> *Do you agree that:*
>
> *(b) if a lender was entitled to demand immediate repayment of a loan because the entity breached a condition of its loan agreement, but agreed by the balance sheet date to provide a period of grace within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as non-current if it is due for settlement, without that breach of the loan agreement, at least twelve months after the balance sheet date and:*
>
> *(i) the entity rectifies the breach within the period of grace; or*

(ii) when the financial statements are authorised for issue, the period of grace is incomplete and it is probable that the breach will be rectified?

The Board confirmed its proposal that management should continue to classify such a long-term financial liability as non-current if the lender agreed by the balance sheet date to provide a period of grace within which the breach of the loan agreement can be rectified and if during that time the lender cannot demand immediate repayment.

The Board decided that if the breach of a loan agreement was not rectified by the time the financial statements were authorised for issue, management should continue to classify such a long-term financial liability as non-current if, and only if, the period of grace is for at least 12 months at the balance sheet date.

The Board noted that the FASB would be considering the classification of long-term financial liabilities in the near future in the context of the two Boards' joint project on Convergence.

Question 5

Do you agree that an entity should disclose the judgements made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements?

The Board confirmed its decision to require disclosure in the financial statements of management's judgement in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements.

The Board decided to include guidance in the revised standard to assist preparers in applying this disclosure requirement.

Question 6

Do you agree that an entity should disclose key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year?

The Board confirmed its decision to require management to disclose in the financial statements key assumptions about the future, and other sources of measurement uncertainty, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

The Board decided to include guidance in the revised standard to assist preparers in applying this disclosure requirement. They also wished to avoid, through clarification, some misunderstanding evident in submissions in relation to future events.

The Board agreed to clarify in the revised standard that disclosure of measurement uncertainties under paragraph 110 for items using observed market prices at the balance sheet date is not required.

The Board will consider at its meeting in December 2002 issues raised by commentators on other changes to IAS 1 proposed in the ED.

IAS 16 *Property, Plant and Equipment*

Question 1

*Do you agree that all exchanges of items of **property, plant and equipment** should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably?*

Question 2

*Do you agree that all exchanges of **intangible assets** should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably?*

The Board confirmed its decision that all exchanges of items of property, plant and equipment and all exchanges of intangible assets should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably.

The Board agreed to clarify in the revised standard that all such transactions involving exchanges of items of property, plant and equipment and intangible assets should have a commercial substance and that such transactions should not be accounted for as transactions generating revenue (as opposed to gains) in accordance with the principles in IAS 18 *Revenue*, except if trading of such items was part of the entity's core business.

The Board noted that the FASB would be considering this issue in the near future in the context of the two Boards' joint project on Convergence.

Question 3

Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes temporarily idle or is retired from active use and held for disposal?

The Board confirmed its objective to clarify in the Improvements project that IAS 16 prohibits management from ceasing to depreciate an item of property, plant and equipment when it becomes temporarily idle or is retired from active use and held for disposal.

The Board noted that the continuing depreciation of items of property, plant and equipment held for disposal would be addressed separately as part of the Board's joint project with the FASB on Convergence.

The Board also discussed the following points raised by commentators on other changes proposed in the ED.

Scope

The Board confirmed its decision that management should apply the requirements in IAS 16 when accounting for items of property, plant and equipment used in the exploration for and extraction of minerals.

Depreciation of an item of property, plant and equipment

The Board decided to provide guidance in the revised standard regarding the point in time when management should start depreciating an item of property, plant and equipment. The Board noted that such guidance regarding the depreciation of an intangible asset was included in IAS 38 *Intangible Assets*, and agreed to include similar guidance in IAS 16.

Application of the component approach

The Board agreed that the principle in the proposed paragraph 22A does not permit capitalisation of routine repairs.

Administration and general overhead costs

The Board confirmed its decision that administration and general overhead costs are excluded from the cost of an item of property, plant and equipment. The Board noted that the components of cost in IAS 2 *Inventories* are different and that IAS 2 permits allocation of certain overhead costs when determining cost of inventories.

Contributions and non-reciprocal transfers of assets

The Board decided that it would not address the treatment of donated assets in 'Improvements' to IAS 16 and that this issue will be addressed within its Convergence project together with the revision of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

Review of residual value at each balance sheet date

The Board decided to include in the revised standard guidance on depreciating an item of property, plant and equipment when the review of residual value at the balance sheet date would result in an amount exceeding depreciated cost.

IAS 17 *Leases*

> Question 1
>
> *Do you agree that when classifying a lease of land and buildings, the lease should be split into two elements—a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the buildings element is classified as an operating or finance lease by applying the conditions in paragraphs 3-10 of IAS 17.*

The Board confirmed its decision that for a lease of both land and buildings, the land and buildings element should be considered separately for the purposes of lease classification, unless title to both elements is expected to pass to the lessee by the end of the lease term. The buildings element should be classified as a finance lease or an operating lease in accordance with the criteria in IAS 17. When the land has an indefinite economic life, the land element is classified as an operating lease unless title passes in accordance with IAS 17 paragraph 11.

> Question 2
>
> *Do you agree that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?*

The Board confirmed its decision that initial direct costs incurred by lessors in negotiating a lease should be capitalised and allocated over the lease term. The Board also confirmed that initial direct costs include internal costs that are incremental and directly attributable.

The Board reiterated its previous comments that the proposed amendments to IAS 17 were limited in view of its comprehensive project on lease accounting being undertaken jointly with the UK ASB.

IAS 27 *Consolidated and Separate Financial Statements*

> Question 2
>
> *Do you agree that minority interests should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity?*

The Board confirmed its decision in the Improvements project that minority interests should be presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity.

The Board also confirmed that all other presentation and measurement issues resulting from this classification in the balance sheet would be addressed as part of the phase II of its project on Business Combinations.

The Board will consider comments received on questions 1 and 3 in the invitation to comment on the proposed revisions to IAS 27 at its meeting in December 2002.

IAS 40 *Investment Property*

> Question 1
>
> *Do you agree that the definition of investment property should be changed to permit the inclusion of a property interest held under an operating lease provided that:*
>
> *(a) the rest of the definition of investment property is met; and*
>
> *(b) the lessee uses the fair value model set out in IAS 40, paragraphs 27-49?*
>
> Question 2
>
> *Do you agree that a lessee that classifies a property interest held under an operating lease as investment property should account for the lease as if it were a finance lease?*

The Board confirmed its decision to change the definition of investment property to permit a lessee to classify a property interest held under an operating lease as investment property provided that the rest of the definition of investment property is met, the lessee uses the fair value model in IAS 40 and the property interest held under an operating lease is accounted for as if it were a finance lease.

> Question 3
>
> *Do you agree that the Board should not eliminate the choice between the cost model and the fair value model in the Improvements project, but should keep the matter under review with a view to reconsidering the option to use the cost model in due course?*

The Board noted that, in general, commentators agreed with its decision not to eliminate the choice between the cost model and the fair value model in the Improvements project but to keep the matter under review with a view to reconsidering the option to use the cost model in due course.

Insurance contracts (phase I)

The Board discussed the following aspects of phase I of the project on insurance contracts:

- application of IAS 39 *Financial Instruments: Recognition and Measurement* to investment contracts (contracts that do not contain enough insurance risk to qualify as insurance contracts)
- measurement of financial assets backing investment contracts and insurance contracts
- unbundling
- derivatives embedded in insurance contracts.

Investment contracts

Many insurers (both direct insurers and reinsurers) issue investment contracts. Under IAS 39, the issuer would measure investment contracts at either amortised cost or, if the issuer designates them at inception, at fair value. (The proposal to permit measurement at fair value is in the June 2002 Exposure Draft of improvements to IAS 39.)

The Board discussed whether it should add further application guidance to IAS 39 to clarify how insurers should apply the requirements of IAS 39 to investment contracts. The Board concluded that no such guidance was needed.

However, the Board also noted that while the application of IAS 39 to the investment contracts is clear, it would represent a change for many insurers. The Board directed the staff to highlight some of the following topics in implementation guidance published with the exposure draft for phase I. As they relate to the accounting for contracts issued by insurers that do not meet the definition of an insurance contract:

- The definition and treatment of transaction costs under IAS 39. These differ from the definition and treatment of acquisition costs in some national GAAP.
- The condition in IAS 39 paragraph 64 for treating a modification of a financial liability (or the exchange of the new liability for an old liability) as an extinguishment of the original liability.
- Sales inducements to customers, such as immediate additions to an account at inception, temporary enhancements to the interest rate or persistency bonuses.
- Clarification of whether costs of administering an investment contract over its life are included in the computation of amortised cost or estimate of fair value.
- Clarification that future cash flows from assets should not be considered in determining the amortised cost or fair value of investment contract liabilities (except for performance-linked contracts, which the Board will address at a later meeting).

- Insignificant insurance risk in investment contracts. By definition, an investment contract does not contain significant insurance risk. If contracts contain so much insurance risk (in aggregate) that this creates measurement difficulties, the contracts should be classified as insurance contracts, not investment contracts.
- The implications for amortised cost measurements of a liability if future cash flows differ from previous estimates.
- Clarification that the amortised cost of a financial liability is not adjusted when market interest rates change, even if the return on available assets is below the effective interest rate on the liability, unless the change in rates causes the liability cash flows to change.
- How to determine the effective interest rate (for amortised cost) if a contract has more than one internal rate of return.
- The requirement (already explicit in paragraph 100 of IAS 39) that the fair value of a financial instrument should reflect the creditworthiness of the debtor.
- The unit of account for determining amortised cost and fair value.
- Initial gain or loss if an insurer measures an investment contract at fair value and the fair value at inception differs from the net proceeds received.
- The fact that premiums received for an investment contract would not be recognised as revenue under IAS 39, but as balance sheet movements, like a deposit received.
- Whether hedge accounting is permitted if an insurer hedges voluntary increases in interest credited on an insurance contract liability. (The FASB's Derivatives Implementation Group (DIG) addressed this topic in issue G4 *Cash Flow Hedges: Hedging Voluntary Increases in Interest Credited on an Insurance Contract Liability*.)

Transaction costs for some long-term investment contracts are proportionately much larger than for most other financial instruments. In addition, the revised definition of transaction costs under the proposed Exposure Draft of improvements to IAS 39 excludes all internal costs, including transaction commissions paid to employees. The Board will consider the implications of these matters when it reviews the comment letters on the proposed improvements to IAS 39.

Financial assets backing investment contracts and insurance contracts

The Board agreed that it should not:

- create a new category of financial assets (financial assets held to back insurance liabilities) that could be held at amortised cost.
- create new exemptions in IAS 39 that would permit an insurer to continue following national GAAP (or US GAAP) temporarily for some investment contracts.
- prohibit so-called "shadow accounting" adjustments in phase I for insurance contracts as defined under IFRSs. US insurers make such adjustments to some insurance liabilities that are measured on a basis reflecting realised investment gains and losses (among other things). These adjustments modify the measurement to reflect recognised but unrealised investment gains and losses.
- introduce "shadow accounting" for investment contracts under IAS 39. Under IAS 39, the measurement of investment contract liabilities is independent of the asset measurement.

Unbundling

Some insurance contracts contain both insurance components and investment components. The Board agreed tentatively that an insurer should:

- unbundle deposit-like components from insurance contracts if the cash flows from the insurance component do not affect the cash flows from deposit-like component.
- treat the insurance component as an insurance contract.
- treat the deposit-like component as a financial liability or financial asset under IAS 39 or, if appropriate, as funds under management. Among other things, this implies that the insurer should not recognise premium receipts for the investment component as revenue.

The Board also discussed whether an insurer should unbundle obligations to provide investment management services (and associated rights to collect fees) from a host insurance contract or investment contract in which those obligations and rights are embedded. The Board directed the staff to prepare illustrations for discussion at a future meeting.

The Board noted that some of the life insurance contracts that are known in some countries as universal life may have deposit-like components or investment management components that could require unbundling under the criteria discussed above. These contracts have variable terms and grant a measure of discretion to both the insurer and the policyholder. They use a policyholder account that functions much like an account with a bank or broker. The policyholder's premiums are credited to this account, as are investment earnings, and the account is charged for administration and mortality protection. On surrender, the policyholder is entitled to the account balance, less any surrender charges. The Board agreed tentatively that it would not create additional unbundling requirements for these contracts.

Embedded derivatives

IAS 39 requires an entity to separate an embedded derivative from the host contract and account for it separately if three conditions are met:

(a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;

(b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and

(c) the hybrid (combined) instrument is not measured at fair value with changes in fair value reported in profit or loss.

The Board focused its discussion on the phrase "closely related" in the first condition and the related examples in IAS 39. The Board agreed to make the following modifications to the versions of those examples that are set out in the June 2002 Exposure Draft of improvements to IAS 39:

(a) a derivative embedded in an insurance contract is regarded as closely related to the host insurance contract if payment is made only if an identifiable insured event occurs (provided that the derivative is not leveraged in relation to the host insurance contract). For example, a component that is a derivative that can be obtained by the policyholder only on death is regarded as closely related to a host insurance contract. The staff will develop wording for the restriction on derivatives that are leveraged in relation to the host insurance contract.

(b) a put option or cash surrender option embedded in a financial instrument or insurance contract that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies based on the change in an equity or commodity price or index is not closely related to a host instrument. (This example extends an existing example that refers explicitly to financial instruments but not to insurance contracts.)

If separate accounting is required for an embedded derivative that an entity is unable to measure separately, IAS 39 requires the entity to measure the entire instrument at fair value and recognise changes in fair value in the income statement. However, under the above proposal, if payment is contingent on an identifiable insured event, the embedded derivative is regarded as closely related to the host insurance contract. The insurer would not need to account separately for the embedded derivative or to measure the entire contract at fair value.

The Board also noted the following consequences of existing guidance in IAS 39 (and the improvements to IAS 39 proposed in the June 2002 Exposure Draft):

- an embedded floor or cap on the interest rate on a debt instrument (or, by analogy, an insurance contract) is closely related to the host debt instrument, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the instrument is issued, and the cap or floor is not leveraged in relation to the host instrument.
- equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract – by which the amount of interest or principal is indexed to the value of equity instruments – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
- a call, put, or prepayment option embedded in a host debt instrument or insurance contract is not closely related to the host instrument unless the option's exercise price is approximately equal to the debt instrument's amortised cost (or the insurance contract's carrying amount) on each exercise date. However, many of these options will not meet the definition of a derivative in IAS 39, in which case separate accounting will not be required.

The staff will consider whether it would be useful for the phase I exposure draft to include examples of embedded derivatives, indicating whether IAS 39 requires separate accounting for those derivatives.

Other areas

The following topics will be the subject of later discussions:

- cancellation and renewal options;
- performance-linked contracts;
- insurance contracts acquired from other insurers or in business combinations; and
- disclosure.

Liabilities and equity

The Board considered a paper prepared by FASB staff entitled *Liabilities and Equity: Comparison of FASB and IASB positions*. The paper identifies potential convergence issues between a proposed FASB Statement of Financial Accounting Standards on liabilities and equity and the exposure draft of proposed Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation*, and IAS 39 *Financial Instruments: Recognition and Measurement*. The proposed FASB Statement would complete phase I of the FASB's project on liabilities and equity, and deals with the following instruments:

- shares that must be redeemed for a specified or determinable amount
- forward contracts to purchase own shares and written put options on own shares
- obligations that the issuer must or can settle by issuing shares, the value of which at settlement either:
  - equals an amount fixed at inception; or
  - varies in response to a variable other than the share price.

The purpose of the Board's discussion was informational only and no decisions were made about IAS 32 and IAS 39. The Board noted that for instruments within the scope of the proposed FASB Statement, the Board's proposals in the ED of improvements to IAS 32 are broadly consistent with the FASB's proposals concerning what instruments would be classified as equity, rather than as debt or derivatives.

The Board also noted that differences exist between the FASB's and IASB's proposals for whether those instruments not classified as equity would be classified as derivatives or debt. This classification affects:

- whether the instruments are recognised net (the treatment for derivatives) or gross (the treatment for debt); and
- whether the instruments are measured at fair value (the treatment for derivatives) or amortised cost (the treatment for debt).

Examples of items for which these potential differences were noted are forward contracts to repurchase the entity's own shares and written put options on the entity's own shares. Under the FASB's proposals, these instruments would be classified as derivative liabilities without reclassifying the related equity instrument. However, under the proposed improvements to IAS 32 the instrument would be accounted for by reclassifying the related equity instrument as debt if:

- the terms of the instrument require physical settlement (that is, by exchanging the full stated amount of cash for the full stated number of shares);
- the issuer has the option to settle physically and the entity's established practice and intent is to settle that way; or
- the holder has the option to settle physically.

In addition, the Board noted that these classification differences might arise because of differences between the definitions of a derivative in IAS 39 and FASB Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*. FASB Statement No. 133 specifies a derivative instrument must be subject to net settlement. In contrast, IAS 32 requires only that a derivative be settled at a future date.

Revenue recognition

The Board discussed the application of an assets and liabilities approach to revenue recognition against the specific cases involving multiple-element revenue arrangements discussed in the US Emerging Issues Task Force's Draft Abstract *Accounting for Revenue Arrangements with Multiple Deliverables* (EITF Issue No. 00-21). The Board explored the similarities and differences between an assets and liabilities approach and the EITF approach (which focuses on when revenue is earned and whether delivering an element in an arrangement represents a separate earning process from delivery of other elements).

The Board tentatively agreed that the case studies examined indicate that, in many cases, similar outcomes will result from applying either approach. The Board noted that applying an assets and liabilities approach has the following advantages over the EITF's approach:

- it is not dependent on whether the delivered item is sold separately by any vendor or the customer could resell the deliverable.
- the existence of rights of return does not have the potential to preclude the recognition of revenue for delivered items. However, the Board noted that rights of return might create liabilities not discussed in the example cases.
- when a delivered asset in a multiple-element arrangement is inseparable from the undelivered items, an assets and liabilities approach avoids the need to recognise a "deferred debit" as an asset when the asset sacrificed is derecognised.
- it measures the value of undelivered items by direct reference to a measurement attribute (for example, fair value) rather than through an allocation process. This means there is a specific measurement objective for liabilities for undelivered items, which assists reliable measurement of those liabilities, particularly after their initial recognition. It also avoids assuming the same margin on each inseparable deliverable in a multiple-element arrangement.

However, the Board also noted that both the assets and liabilities approach and the EITF approach are dependent on the availability of reliable information about the fair values of assets and liabilities.

The Board also tentatively agreed that:

- on the basis of its analysis of the case studies, the assets and liabilities approach to revenue recognition provided an appropriate analytical model for proceeding with this project.
- at this stage of the project, revenue arrangement case studies should use fair value as the measurement attribute for initial recognition and any remeasurement of assets and liabilities.
- the fair value of a liability for undelivered items in a revenue arrangement should be measured in terms of the price that the entity would need to pay a third party to assume the responsibility for delivering those items.
- the effects of a vendor's obligations with respect to refund rights should be reflected in measurement (rather than determining whether any revenue should be recognised); and
- it would be necessary to explore some aspects of the treatment of executory contracts as a part of this project.

Meeting dates: December 2002 – December 2003

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

18 – 20 December

22 – 24 January 2003

19 – 21 February†

19 – 25 March

24 April – 2 May‡

21 – 23 May

16 – 20 June†, Rome, Italy

23 – 25 July

17 – 23 September‡

22 – 24 October, Toronto, Canada

17 – 21 November†

17 – 19 December

† Includes a meeting with the Standards Advisory Council

‡ Includes a meeting with partner national standard-setters