

The International Accounting Standards Board met in London on 29 April – 2 May 2003, when it discussed:

- Business combinations (phase II)
- Extractive industries
- Financial instruments
- First-time adoption of IFRSs
- IAS 12 *Income Taxes*
- IAS 16 *Property, Plant and Equipment*
- IFRIC issues
- Insurance contracts (phase I)
- Joint ventures
- Share-based payment

Business combinations (phase II)

Attributing a partially owned subsidiary's excess losses to the controlling and minority interests

In December 2002, the Board decided that losses of a partially owned subsidiary should be attributed to both the controlling and minority interests on the basis of their ownership interests and any contractual rights and obligations, even if the losses exceed the minority interests' investment in that subsidiary. At this meeting the Board further considered whether the existence of a guarantee or other type of arrangement with the subsidiary or third parties should change the way losses are attributed between the controlling and minority interests. The Board agreed that the existence of such arrangements should be accounted for separately; they should not change the way losses are attributed between the controlling and minority interests. Therefore, losses of a subsidiary should be attributed to both the controlling and minority interests on the basis of their ownership interests and contractual rights and obligations (for example, income sharing arrangements), if any, even if the losses exceed the minority interests' investment.

Business combination disclosures

The Board considered whether, as a result of decisions in the joint project with the FASB on phase II, changes are needed to the disclosure requirements proposed in ED 3 *Business Combinations*.

The Board noted that the terminology in the disclosure requirements of ED 3 would be modified during the drafting process. The objective of such modifications is to ensure

consistency with the language of the joint working principle.

The Board agreed to add a disclosure requirement for contingent assets acquired, contingent liabilities assumed, and contingent consideration recognised initially at fair value that are not subsequently accounted for under current IASB guidance. For those assets and liabilities, the Board agreed to require the disclosures in paragraphs 84 and 85 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Comment period, effective date and transition provisions

The Board considered the comment period, proposed effective date and transitional provisions for the forthcoming Exposure Draft resulting from this project.

The Board agreed to adopt a 90-day comment period that would give constituents sufficient time to analyse the ED and develop comments.

The Board agreed that the final Standard resulting from this project should require prospective application for business combinations for which the agreement date is after the effective date. In addition, the proposed Standard should preclude retroactive application or adjustments of amounts recognised in combinations occurring before the Standard is issued. The Board also agreed that the ED should propose that the final Standard be effective for annual reporting periods beginning on or after January 1, 2006, with early application encouraged.

Convergence issues

The Board considered differences between the IASB's and the FASB's conclusions in the joint project to explore whether there may be opportunities to eliminate differences prior to issuing the Exposure Drafts. Different tentative conclusions by the IASB and FASB result from different views about which assets and liabilities should be included as part of the business combination transaction. The Board directed the staff to explore this issue further.

Consequential amendments

The Board considered consequential amendments that will need to be made to IFRSs as a result of tentative decisions the Board made about minority interests in this project. Specifically, the Board considered whether gains and losses relating to the subsidiary that have been recognised in equity should be 'recycled':

- (a) when the parent increases or decreases (without loss of control) its ownership interest in the subsidiary or
- (b) when the parent loses control of the subsidiary.

The Board agreed that after a parent obtains control of a subsidiary, subsequent increases or decreases (without loss of control) in the ownership interests in the subsidiary by members of the consolidated group should not result in gains and losses, relating to the subsidiary that have been recognised in equity, being subsequently recognised in profit or loss ('recycled').

When the parent loses control of the subsidiary, gains and losses relating to net assets of that subsidiary that have been recognised in the parent's equity should be reflected in profit or loss ('recycled') if such gains and losses otherwise would be reflected in profit or loss on the disposition of a single asset or a liability, ie in the absence of being disposed of as part of the subsidiary. The Board agreed that a disposal of a subsidiary is effectively a disposal of its underlying net assets. Therefore, general requirements in IFRSs should be followed with respect to gains and losses relating to net assets of the subsidiary that have been recognised in equity.

The Board also agreed that:

- (a) IAS 21 *The Effects of Changes in Foreign Exchange Rates* should clarify that the parent's portion of the cumulative amount of exchange differences that relates to a foreign subsidiary should be recognised in profit or loss only when control of the foreign subsidiary is lost rather than when the parent's ownership interest decreases;
- (b) IAS 39 *Financial Instruments: Recognition and Measurement* should clarify that the effective portion of hedges

(continued...)

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Business combinations (phase II) (continued)

of a net investment in a foreign subsidiary attributable to the parent should be recognised in profit or loss only when control of the foreign subsidiary is lost rather than when the parent's ownership interest decreases.

The Board considered classification of cash flows relating to changes in the parent's ownership interests in the subsidiary (without loss of control). The Board agreed that IAS 7 *Cash Flow Statements* should be amended to clarify that changes in ownership interests in the subsidiary which do not result in control being obtained or lost should be classified as financing activities.

Recognition and measurement of deferred tax assets

The Board reconsidered its previous decision relating to the subsequent recognition of deferred tax benefits acquired in a business combination that did not satisfy the criteria for separate recognition when a business combination was recognised initially, but that are subsequently realised. The Board agreed that the acquirer should reduce the carrying amount of goodwill to the amount that would have been recognised if the deferred tax asset had been recognised as an identifiable asset at the acquisition date under IAS 12 *Income Taxes*.

Any excess of the deferred tax benefit subsequently realised over the carrying amount of goodwill acquired in the business combination should be recorded as a gain in profit or loss.

Decision summary and comparison of IASB and FASB conclusions in phases I and II

The Board considered a decision summary outlining all tentative decisions made by the Board in phase II of the business combinations project. The Board agreed that its decisions in this project should be revised to be consistent with the revised wording of the working principle. The Board agreed to proceed with the preparation of pre-ballot Exposure Draft incorporating all of the tentative decisions included in the decision summary, subject to decisions resulting from further consideration of:

- (a) which assets and liabilities should be included as part of the business combination transaction; and
- (b) the implications of applying or not applying the full goodwill method.

Drafting plan

During its discussions of *Principle Based Standards*, the FASB decided that one of its near-term objectives should be to use identical style and wording in the standards issued by the FASB and IASB on joint projects. The Board discussed how the IASB and the FASB could work together to achieve that objective on this project. The Board noted that to the extent possible the Exposure Drafts resulting from this project would be similar in most respects for the decisions reached jointly.

Convergence

IAS 12 *Income Taxes*

The Board discussed the following differences between FASB Statement 109 *Accounting for Income Taxes* and EITF 98-11 *Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations* (collectively 'US GAAP') and IAS 12:

- exceptions to the basic principle
- measurement criteria for deferred tax assets and liabilities
- recognition criteria for deferred tax assets
- allocations to shareholders' equity ("backwards tracing")
- balance sheet classification of deferred tax assets and liabilities

Exceptions to the basic principle

Both IFRS and US GAAP take a similar basic approach to accounting for income taxes. The standards adopt a balance sheet liability

approach and recognise deferred tax liabilities and assets for temporary differences and for operating loss and tax credit carryforwards. Temporary differences are differences between the carrying amount of an asset or liability in the balance sheet and its tax base. Both standards have exceptions to the basic principles.

IAS 12 prohibits recognition of a deferred tax liability or deferred tax asset for temporary differences that arise from the initial recognition of an asset or liability in a transaction that:

- (a) is not a business combination, and
- (b) at the time of the transaction affects neither accounting nor taxable profit ('initial recognition exemption').

Furthermore, IAS 12 states explicitly that an entity does not subsequently recognise changes in this unrecognised deferred tax asset or liability.

FAS 109 does not provide this exception. The Board tentatively decided to eliminate the initial recognition exception but directed the staff to work with the FASB staff to resolve some potential issues with other parts of US GAAP and to develop an alternative solution.

The Board discussed the fact that IAS 12 and FAS 109 provide exceptions with respect to investments in subsidiaries, branches and associates and interests in joint ventures. However, there are differences in how these exemptions are applied. The Board expressed concern about the exceptions and directed the staff to analyse them further.

US GAAP provides a specific exception to the basic principle of accounting for income taxes for leveraged leases. IAS provides no such exception. The Board noted that this difference results from fundamental differences in accounting for leveraged leases. Until the larger issue of lease accounting is addressed (specifically for leveraged leases), this difference cannot be resolved. The Board believes that this is beyond the scope of the short-term convergence project and concluded that no action should be taken with respect to this difference.

An intercompany transfer of assets (such as the sale of inventory or depreciable assets) between tax jurisdictions is a taxable event that establishes a new tax basis for those assets in the buyer's tax jurisdiction. The new tax basis of the assets is deductible on the buyer's tax return as those assets are consumed or sold to an unrelated party. US GAAP requires taxes paid by the seller on intercompany profits to be deferred and prohibits the recognition of a deferred tax asset for any difference resulting from tax base differences between the two jurisdictions. IAS 12 does not provide a similar exception. The Board discussed this issue and directed the staff to develop the analysis further.

US GAAP prohibits recognition of a deferred tax asset or liability for differences related to assets and liabilities that, under FAS 52 *Foreign Currency Translation*, are remeasured from the local currency into the functional currency using historical exchange rates and that result from (a) changes in exchange rates or (b) indexing for tax purposes. In contrast, IAS 12 requires recognition of a deferred tax liability or asset for those temporary differences. The Board discussed this issue and directed the staff to develop the analysis further.

Measurement criteria for deferred tax assets and liabilities

IAS 12 requires an entity to measure its deferred taxes using the 'substantially enacted' tax rate as of the balance sheet date. US GAAP requires an entity to use the enacted tax rate. The Board tentatively decided that the use of the 'substantially enacted' rate is appropriate and that IAS 12 should not be amended. The Board also decided that IAS 12 should be amended to clarify that 'substantially enacted' means that any anticipated change in the tax rate is virtually certain. The Board noted that in some jurisdictions, (eg the US), enactment may not be virtually certain until the change is signed into law.

In measuring deferred tax assets and liabilities, IAS 12 requires use of the tax rate applicable to undistributed profits. US GAAP provides the option to use the tax rate applicable to distributed profits if the tax rate applicable to distributed profits is higher than the tax rate applicable to undistributed profits. The Board tentatively decided that the tax rate

applicable to undistributed profits is generally appropriate. However, if there were an obligation to distribute a portion of those profits, any deferred taxes on that portion would be measured at the distributed rate.

Recognition criteria for deferred tax assets

Under IAS 12, a deferred tax asset is not recognised unless it is 'probable' that it will be realised. Under FAS 109, all deferred tax assets are recognised and a valuation allowance is recognised to the extent that it is 'more likely than not' that the deferred tax assets will not be realised. This results in a difference in presentation as well as disclosure requirements. The Board tentatively decided not to amend IAS 12 to in order to converge with FAS 109.

In the United States and some other jurisdictions, the term 'probable' is generally understood as a higher level of likelihood than 'more likely than not.' In some other countries, 'probable' means a likelihood that is about the same as 'more likely than not'. Thus, depending on how the meaning of 'probable' is interpreted, the recognition of deferred tax assets under IAS 12 may or may not differ significantly from those recognised under FAS 109. The Board agreed that the threshold for recognition should be 'more likely than not'. IAS 12 should be amended to clarify that, consistent with FAS 109, 'probable' means 'more likely than not' for the purposes of this Standard.

Allocations to shareholders' equity ("backwards tracing")

IAS 12 and FAS 109 require that the tax effects of items credited or charged directly to equity during the current year also be allocated directly to equity. IAS 12 and FAS 109 differ, however, with respect to the allocation of current year deferred taxes related to an item that was credited or charged directly to equity in a prior year. Such items may arise from either changes in assessments of recovery of deferred tax assets or changes in tax rates, laws, or other measurement attributes. IAS 12 requires the allocation of the current year deferred taxes directly to equity, while FAS 109 requires allocation to current year income. The Board discussed the complexity of the requirement and directed the staff to work with the FASB to develop the analysis further.

Balance sheet classification of deferred tax assets and liabilities

In a statement of financial position that distinguishes between current and non-current assets and liabilities, IAS 12 requires classification of all deferred tax assets and liabilities as non-current. FAS 109 requires classification of deferred tax assets and liabilities as either current or non-current based on the classification of the related nontax asset or liability for financial reporting. The Board tentatively decided to amend IAS 12 to converge with FAS 109.

IAS 16 Property, Plant and Equipment

Exchanges of assets

An entity may acquire an item of property, plant and equipment in exchange for a nonmonetary asset or monetary and nonmonetary assets. The Board had previously concluded that an entity would measure the acquired item at fair value unless either the exchange transaction lacks commercial substance, or the fair value of neither asset exchanged is reliably measurable.

At this meeting, the Board decided that an entity determines whether an exchange transaction has commercial substance by considering the degree to which its future cash flows have changed as a result of the transaction. An exchange transaction has commercial substance if:

- (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset(s) transferred; or
- (b) the present value of the cash flows the entity expects to derive from the portion of its operations affected by the transaction has changed; and
- (c) either of the differences in (a) and (b) is significant relative to the fair value of the assets exchanged.

The Board observed that if the result of these analyses is clear, an entity could conclude that a transaction has commercial substance without performing detailed calculations.

The Board noted that the wording of the guidance in IAS 16 for assessing whether the value of an asset is reliably measurable differs from the comparable guidance in APB Opinion No. 29 *Accounting for*

Nonmonetary Transactions (APB 29). To foster convergence with US GAAP, the Board concluded it would be helpful to observe that both sets of guidance are intended to have the same meaning.

The Board clarified that its proposed scope is acquisitions of assets to be accounted for under IAS 16, IAS 38 *Intangible Assets*, and IAS 40 *Investment Property*. The Board also observed that although the guidance does not address the entity's derecognition of the asset(s) transferred, measurement of an item acquired in an exchange transaction involving delayed settlement is nonetheless within the scope. The Board decided to proceed with its proposed scope for this guidance, despite the fact that it is narrower than the scope of APB 29. The Board may consider converging those scopes at a later date.

Depreciation—residual value

The residual value of an item of property, plant and equipment may increase to an amount equal to or greater than its carrying amount. The Board decided that an entity would stop depreciating that item until its residual value subsequently decreased to an amount below its carrying amount.

Extractive industries

The Board discussed the following matters prepared by a project team from a group of national standard-setters (Australia, Canada, Norway and South Africa):

- (a) Possible amendments to IFRSs prior to 2005
- (b) Possible disclosure changes to IFRSs prior to 2005
- (c) Proposals for a long-term project
- (d) National accounting principles for extractive industries from around the world
- (e) A draft exposure draft of interim guidance for extractive industries.

The Board noted that financial reporting of extractive industries activities is diverse and that the various national GAAPs are sometimes formalised in standards and sometimes not. The Board also noted that practices differ among extractive industries entities applying existing IFRSs.

The Board noted that there are differing interpretations of how the IASB's hierarchy (at present in IAS 1 *Presentation of Financial Statements* and proposed to be included in [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) would apply to extractive industries' activities. Some Board Members consider that some present practices could be justified under the hierarchy, while others maintain that the full cost method and some forms of the successful efforts method of reporting pre-development costs would not comply with the IASB *Framework* (or IAS 38 *Intangible Assets* if it applies).

There were also mixed views on how the hierarchy applies by analogy to a standard if that standard scopes out the activity in question. Some Board Members expressed the view that the analogous standard should still be applied under the hierarchy, while others think the scope exclusion means that the Board could not have intended the standard to be applied via the hierarchy.

The Board reviewed a draft exposure draft noting that it represented an 'initial draft' only and did not contain all sections required for an exposure draft, particularly with respect to the basis for conclusions.

The Board tentatively agreed that:

- (a) IFRSs apply to entities engaged in extractive industries activities
- (b) costs incurred in exploration and evaluation prior to the adoption of IFRSs could continue to be accounted for using existing accounting policies
- (c) such costs could be exempt from the concept of cash generating units for the purposes of impairment tests under IAS 36 *Impairment of Assets*.

Some Board Members were opposed to grandfathering existing practice in respect of costs incurred in exploration and evaluation. Some Board Members expressed concerns about a reference to an entity's jurisdiction in respect of the practice to be grandfathered. Some Board Members thought that there was no need to specify that IFRSs shall be applied by entities engaged in extractive industries activities (except as specified in the exposure draft): this was clear

from the scope of each Standard and IAS 1. Others viewed this clarification as beneficial.

Some Board Members expressed concerns in respect of the definition of the cash generating unit level at which IAS 36 would apply to costs incurred in exploration and evaluation and/or extractive industries activities. The Board noted that entities conducting extractive industries activities should still be required to apply IAS 36, however, it was more an issue of when IAS 36 would apply to costs incurred in exploration and evaluation and at what level.

Although the proposed interim guidance would be exposed as a single document, it would likely consist of proposed amendments to existing Standards (eg IAS 16 *Property, Plant and Equipment*, IAS 36 and IAS 38), rather than creating a separate IFRS.

The Board agreed that further detailed work would be required on the proposed exposure draft and specifically that input was needed from those in industry.

Financial instruments

Improvements to IAS 32 *Financial Instruments: Disclosure and Presentation*

Contracts on an entity's own equity instruments

The Board considered the classification of financial instruments that are indexed to, or settled in, own equity instruments as assets/liabilities or equity under IAS 32.

The Board agreed to confirm the fundamental approach to classifying contracts on own shares set out in the Exposure Draft of proposed amendments to IAS 32 and IAS 39. The ED proposed precluding equity classification for contracts that either involve an obligation to deliver cash or other assets, or may be settled using a variable number of own shares as the means for payment. More specifically, the Board agreed that:

- (a) A contract that will be settled by the entity unilaterally delivering a fixed number of own shares, or delivering a fixed number of own shares in exchange for receiving a fixed monetary amount of cash or other assets, is equity. One example is an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed amount of cash.
- (b) A contract that requires an entity to repurchase (redeem) its own shares for cash or other financial assets at a fixed or determinable date or on demand gives rise to a liability for the redemption amount. One example is a forward contract for the entity to repurchase its own shares for cash.
- (c) An obligation to redeem own shares for cash gives rise to a liability for the redemption amount even if the obligation is conditional on the counterparty exercising a right to redeem. One example is an issued option requires the entity to repurchase its own shares for cash, if the counterparty exercises the option.
- (d) A contract that will be settled in cash or other assets is an asset or liability even when the amount of cash that will be received or delivered is based on changes in the market price of the entity's own equity. One example is a net cash-settled share option.
- (e) A contract that will be settled in a variable number of own shares determined so as to equal a fixed value or a value based on changes in an underlying variable (eg a commodity price) is an asset or liability. One example is a forward contract on the price of gold that is settled in own shares. Such a contract is an asset or liability even if the underlying variable is the entity's own share price.
- (f) When a contract has multiple settlement alternatives, it is an asset or liability. One example is a share option that the entity can decide to settle either net in cash or by delivering own shares for cash. The exception to this requirement proposed in the Exposure draft based on an entity's intent, ability and past practice of settlement should be eliminated. Similarly, a consequential amendment to IAS 33 *Earnings Per Share* to eliminate the consideration of an entity's past practice of settlement would be considered.
- (g) Changes in the fair value of a contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be paid or received or the number of equity

instruments to be received or delivered on settlement of the contract do not preclude it from being equity. This will be clarified in the final Standard.

- (h) The final Standard would emphasise the underlying principle.
- (i) Amendments to the definitions of a financial asset, a financial liability and an equity instrument in IAS 32 to reflect these decisions would be considered.

Economic compulsion

The Board considered the proposed deletion from IAS 32 paragraph 22 of the example of a preferred share with a contractually accelerating dividend. Respondents had expressed concern that the deletion of the example signalled that economic compulsion was no longer a factor to be considered in classifying an instrument as a liability or equity. The Board tentatively agreed to clarify its position by adding an explanation to paragraph 22 that terms and conditions of a financial instrument may indirectly create an obligation. The Board directed the staff to refine its proposed wording and present it for discussion at a future meeting.

Contingent settlement provisions

The Board confirmed that a financial instrument with a contingent settlement provision should not be classified as equity when settlement in shares is not wholly within the issuer's control. It also tentatively agreed that:

- (a) contingent settlement provisions that have no realistic possibility of affecting the manner of settlement should be disregarded when classifying a financial instrument as equity or a liability
- (b) a financial instrument with a contingent settlement provision should be evaluated to determine whether it contains liability and equity components. If so it should be treated as a compound instrument rather than being classified as a liability in its entirety
- (c) the proposed addition ("and without regards to probabilities of the manners of settlement") to IAS 32 paragraph 19 should be deleted.

Parent guarantee of distributions

The Board discussed the classification of a subsidiary's equity instrument in the group's consolidated financial statements. The Board tentatively agreed that, to the extent the group has an obligation to transfer cash or another asset, the instrument is classified as a liability in the consolidated financial statements. This can occur when another member of the group agrees additional terms that result in the group as a whole having an obligation to pay distributions or redeem the instrument.

Treatment of derivatives on interests in subsidiaries, associates and joint ventures

The Board tentatively agreed that IAS 32 and IAS 39 should clarify that derivatives on subsidiaries, associates and joint ventures are within their scope of those Standards. They are not interests in such entities to be accounted for under [draft] IAS 27 *Consolidated and Separate Financial Statements*, [draft] IAS 28 *Accounting for Investments in Associates* or IAS 31 *Financial Reporting of Interests in Joint Ventures*.

Offsetting of financial assets and liabilities

The Board discussed whether:

- (a) an intent to settle net should be required before financial assets and liabilities can be offset
- (b) offsetting of a financial liability and asset should be required when the entity has the ability to insist on net settlement.

The Board tentatively agreed that no amendment to IAS 32 should be made.

Puttable instruments

The Board considered the proposal in the Exposure Draft to classify as liabilities puttable instruments (financial instruments that give the holder the right to put the instrument back to the issuer for cash or another asset). The Board tentatively agreed that such instruments are liabilities, but that it would make more explicit the alternative presentations available to entities such as mutual funds or co-operatives.

The Board tentatively agreed to consider amending IAS 1 *Presentation of Financial Statements* paragraph 4 to clarify that such entities may amend the descriptions used for line items in the financial statements.

Treasury Share Transactions

The Board considered whether financial institutions should classify some holdings of their own equity as assets, rather than as a deduction from equity.

The Board tentatively agreed that when an institution holds its own equity on behalf of a client, there is an agency relationship. Consequently the holding would not be included in the entity's balance sheet. The Board tentatively agreed that all other holdings of own equity instruments should be accounted for as a deduction from equity and not as assets.

Separation of liability and equity elements

The Board confirmed the method for separating the liability and equity components of a compound instrument proposed in the Exposure Draft.

Disclosure issues

The Board considered concerns raised by respondents on the risk disclosures and the fair value disclosures.

The Board tentatively agreed:

- (a) to refer comments on the risk disclosures to the Financial Activities Advisory Committee's project to review IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*
- (b) to retain the fair value disclosures proposed in IAS 32 paragraph 77B parts (a) to (c) and (e).

The Board directed the staff to bring to a future meeting a paper reconsidering the proposed disclosure in paragraph 77(d) (of the effect on fair value of a range of reasonably possible alternative assumptions). The Board also asked the staff to determine whether US GAAP or the US Securities and Exchange Commission require similar disclosures.

Improvements to IAS 39 *Financial Instruments: Recognition and Measurement*

Fair value measurement option

The Board considered the fair value measurement option proposed in the Exposure Draft (ie the option to irrevocably designate any financial instrument on initial recognition as one to be measured at fair value with gains and losses reported immediately in profit or loss). Respondents' views were mixed. Some supported the proposals but a significant number were opposed.

The Board tentatively agreed:

- (a) To proceed with the fair value measurement option in the final Standard.
- (b) To clarify how liabilities with a demand feature (eg demand deposits) are to be measured. IAS 39 will state that the fair value of such a liability is not less than the amount payable on demand.
- (c) To have only one category of financial instruments that are measured at fair value with gains and losses reported immediately in profit or loss. It will include both those that are designated under the fair value option and those held for trading. This categorisation applies to measurement and income recognition under IAS 39, not presentation in the balance sheet. The carrying amount of each component of the fair value category will be disclosed separately.
- (d) To require entities to disclose on first adopting IAS 39 the types of financial instruments that were previously designated as held to maturity, available for sale, etc. that are now designated as "fair value through profit or loss" as a result of applying the fair value option.
- (e) Not to consider extending the fair value option to a portion (versus the entirety) of a financial instrument.

Furthermore, the Board tentatively confirmed that changes in the credit risk of a liability should be included in its fair value measurement when the fair value option is used (ie the fair value of financial liabilities is not adjusted to exclude the effect of changes in the liability's creditworthiness). It also tentatively agreed that no disclosure should be required of the effect of changes in a liability's creditworthiness on the fair value of its liabilities.

Basis adjustments

The Board considered whether the proposal in the Exposure Draft to preclude basis adjustments for hedges of forecast transactions that result in the recognition of an asset or liability should be retained in IAS 39.

The Board tentatively agreed that basis adjustments should be prohibited for hedges of forecast transactions that will result in the recognition of a financial asset or financial liability. It decided to consider further at a future meeting whether IAS 39 should provide entities with an option to use basis adjustments for hedges of forecast transactions that will result in the recognition of non-financial assets and non-financial liabilities.

Hedges of firm commitments

The Board confirmed the basic position set out in the Exposure Draft to treat hedges of firm commitments as fair value hedges (rather than as cash flow hedges).

The Board also tentatively agreed that IAS 39 should clarify that a hedge of the foreign currency risk of a firm commitment may be accounted for as either a fair value hedge or a cash flow hedge.

Reversals of impairment on available-for-sale financial assets

The Board considered whether to proceed with the proposal in the Exposure Draft to preclude reversals of impairment on available-for-sale (AFS) financial assets.

The Board tentatively agreed that:

- (a) for AFS equity instruments, all changes in fair value below cost should be reported in profit or loss, and all changes in fair value above cost should be reported in equity.
- (b) for AFS debt instruments, to revert to the existing requirements in IAS 39, namely that impairment should be reversed when the recoverable amount increases and the increase can be objectively related to an event occurring after the loss was recognised.

Proposal to treat hedges of forecast transactions as fair value hedges

The Board tentatively agreed that hedges of forecast transactions should not be treated as fair value hedges. Rather, IAS 39 should continue to require the use of cash flow hedge accounting (rather than fair value hedge accounting) for hedges of forecast transactions.

First-time adoption of IFRSs

The Board discussed:

- assets and liabilities of subsidiaries, associates and joint ventures.
- intangible assets acquired in a past business combination.
- interim financial reporting.

Subsidiaries, associates and joint ventures

A subsidiary may have reported to its parent in the previous period using IFRSs without presenting a full set of financial statements under IFRSs. If the subsidiary subsequently presents financial statements that contain an explicit and unreserved statement of compliance with IFRSs, it becomes a first-time adopter at that time. To avoid compelling the subsidiary to keep two parallel sets of accounting records based on different dates of transition to IFRSs, ED 1 proposed that the subsidiary would not be treated as a first-time adopter for recognition and measurement purposes if the subsidiary was consolidated in IFRS financial statements for the previous period and all owners of the minority interests consented.

The Board agreed to replace that proposal with the following exemption. If a subsidiary becomes a first-time adopter later than its parent, the subsidiary can measure its assets and liabilities at either:

- (a) their carrying amounts in the parent's consolidated IFRS financial statements, before considering the effect of business combinations or eliminating intragroup items; or
- (b) their carrying amounts determined in accordance with IFRSs based on the subsidiary's date of adoption.

A similar election will be available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

The Board also agreed the following:

- (a) An entity may become a first-time adopter later than its subsidiary (or associate or joint venture). In this case, the consolidated financial statements measure the subsidiary's (or associate's or joint venture's) assets and liabilities at their carrying amounts in the subsidiary's (or associate's or joint venture's) separate financial statements, after considering the effect of business combinations and eliminating intragroup items.
- (b) A parent may become a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements. In this case, the parent measures its assets and liabilities at the same amounts in both financial statements, after eliminating intragroup items.

Intangible assets acquired in a past business combination

In March 2003, the Board discussed intangible assets a first-time adopter acquired in a past business combination that it did not recognise under its previous basis of accounting (previous GAAP). At this meeting, the Board clarified that the first-time adopter does not recognise the intangible asset in its consolidated opening IFRS balance sheet, unless the asset would qualify for recognition under IAS 38 *Intangible Assets* at the date of transition to IFRSs in the separate balance sheet of the acquiree.

In many cases, the intangible asset will not meet the recognition criteria, because the acquiree did not:

- (a) have a reliable system for accumulating the costs of internally generated intangible assets when, or shortly after, they are incurred; or
- (b) make and document contemporaneous assessments of the future economic benefits from the asset.

However, if the recognition criteria are met, the acquirer measures the asset on the basis that IAS 38 would require in the separate balance sheet of the acquiree. This measurement is not intended to replicate the fair value that the acquirer would have attributed to the asset at the date of the business combination if it had applied IAS 22 *Business Combinations*.

Interim financial reporting

IAS 34 *Interim Financial Reporting* requires minimum condensed disclosures. Its requirements are based on the assumption that users of the interim financial report also have access to the most recent annual IFRS financial statements. However, the Board noted that IAS 34 also requires an entity to disclose 'any events or transactions that are material to an understanding of the current interim period'. Therefore, if a first-time adopter did not, in its most recent annual financial statements under previous GAAP, disclose information material to an understanding of the current interim period, it would need to disclose that information in its first interim financial report under IFRSs.

Next steps

The Board directed the staff to prepare updated text for written ballot. The Board expects to publish IFRS 1 in June 2003.

IFRIC issues

The Board was informed that the IFRIC had reached a consensus on its proposed Interpretation *Emission Rights* and that the draft Interpretation would be exposed for comment unless five or more Board Members objected to its release. The Board discussed the draft Interpretation and Members have until 7 May to notify the staff of any objections. The Board noted that in the event that five or more members raise objections, the topic would be brought back to the May 2003 Board meeting.

Insurance contracts (phase I)

The Board reviewed a draft Exposure Draft for phase I of the project on insurance contracts and discussed:

- assets backing insurance contracts
- insurance against credit risk and financial guarantees
- disclosure

Assets backing insurance contracts

Participants at the IAS 39 roundtables in March 2003 were concerned that anomalies in reported results could arise due to the phase I project. Such anomalies arise if financial assets (particularly interest-bearing investments) held to back insurance contracts are measured at fair value under IAS 39 whilst insurance liabilities are measured on a different basis in phase I. After discussing various suggestions for resolving these perceived anomalies, the Board decided:

- (a) Not to relax the criteria in IAS 39 *Financial Instruments: Recognition and Measurement* for classifying financial assets as held-to-maturity. The Board noted that an insurer may be able to classify some of its financial assets as held-to-maturity if, in addition to meeting the other conditions set out in IAS 39, it concludes that an unexpected increase in lapses or claims would not compel it to sell those assets (except in the 'disaster scenario' discussed in IAS 39 paragraph 85).
- (b) Not to create a new category of assets carried at amortised cost: assets held to back insurance liabilities.
- (c) Not to create a new category of 'available-for-settlement' liabilities, analogous to available-for-sale assets, measured at fair value, with changes in fair value recognised in equity.

In finalising improvements to IAS 39, the Board intends to discuss whether it should permit broader use of fair value hedge accounting when a non-derivative is used as a hedging instrument ('cash instrument hedge accounting'). However, the Board noted that 'cash instrument hedge accounting' would have requirements to designate and document the hedge at inception and test its effectiveness. Some insurers have noted that they consider those requirements difficult and costly.

The Board also agreed that:

- (a) When an insurer changes its accounting policies for insurance liabilities, it should be permitted, but not required, to reclassify some or all financial assets into the category of financial assets that are measured at fair value, with changes in fair value recognised in profit or loss. This accommodation would apply to changes in accounting policies made either when the insurer first applies the phase I Standard or when it subsequently makes a policy change permitted that Standard. The insurer should recognise the reclassification as a change in accounting policy under [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
- (b) The improvements to IAS 28 *Accounting for Investments in Associates* should clarify that the entities permitted to use a fair value model for investments in associates include not only venture capital organisations, mutual funds, unit trusts and similar entities, but also similar insurance structures in which policyholders participate directly in the risks and returns from those investments.
- (c) Phase I should not introduce an option or requirement for an insurer to treat owner-occupied properties in the same way as investment properties.

Insurance against credit risk and financial guarantees

Contracts that require a third party to make payments to a creditor if a specified debtor fails to make payment when due meet the proposed definition of an insurance contract. Some of these contracts have the legal form of insurance contracts and others have the legal form of financial guarantees or letters of credit. The Board agreed that:

- (a) The issuer of any financial guarantee should recognise a liability at inception.
- (b) The legal form of the contracts (ie insurance contract, financial guarantee or letter of credit) should not affect its recognition and measurement.
- (c) The following contracts should remain within the scope of IAS 39:
 - (i) A financial guarantee arising from the derecognition of assets or liabilities, regardless of whether the guarantee meets the definition of an insurance contract.
 - (ii) A financial guarantee that does not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due (see IAS 39 Implementation Guidance IGC 1-2, IGC 1-5-a and IGC 1-5-)

- b). This contract does not meet the definition of an insurance contract.
- (iii) A financial guarantee contract that provides for payments to be made in response to changes in a specified interest rate, security price, commodity price, credit rating or credit index, foreign exchange rate, index of prices or rates, or other variable (ie a derivative). This contract does not meet the definition of an insurance contract.
- (d) All other contracts that, as a precondition for payment, require the holder to be exposed to, and have incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due, meet the definition of an insurance contract and should be treated in the same way as other insurance contracts.

The Board agreed to include cross-references in both the phase I Standard and IAS 39 to assist insurance companies to identify the standards that apply to a particular contract.

The June 2002 Exposure Draft of improvements to IAS 39 proposed that IAS 39 should deal with all financial guarantees at initial recognition, but that the subsequent measurement of some financial guarantees should remain subject to IAS 37. In finalising the improvements to IAS 39, the Board will review the subsequent measurement of those financial guarantees discussed above that will be within the scope of IAS 39.

Disclosure

The Board reaffirmed a previous decision that an insurer should disclose the fair value of its rights and obligations under insurance contracts from 31 December 2006. However, the Board agreed that it would not, as previously proposed, require an insurer to disclose information from 31 December 2005 about the principal characteristics of those rights and obligations that are pertinent to their fair value. The Board noted that the meaning of this earlier proposal was not clear and that it overlapped other proposed disclosures.

The Board agreed in February that an insurer should disclose information comparing actual claims with previous estimates (claims development). The period covered should include that in which the earliest material incurred claim still outstanding arose, subject to a maximum of ten years. On transition, the Board had agreed previously not to require disclosure of claims development that occurred during periods beginning before 1 January 2004 (for entities already applying IFRSs) and the date of transition to IFRSs (for first-time adopters). However, at this meeting, the Board agreed to a new transitional provision: disclosure would not be required of claims development that occurred earlier than five years before the end of the first year in which an entity applies the Standard.

Next steps

The staff will update the draft Exposure Draft for the Board's review. The Board aims to publish the Exposure Draft around the end of the second quarter of 2003.

Joint ventures

The Board considered an issues paper prepared by the staff of the Australian Accounting Standards Board on *Joint Ventures – Definition* and the accounting treatment for jointly controlled entities.

Definition

The Board considered a proposal to change the definition of joint venture to remove the reference to a contractual arrangement. In making that recommendation, some argued that joint ventures may come about without the existence of a contract.

The Board decided that the existence of a contract is important, and probably essential to determining whether an arrangement is a joint venture.

Joint Venture Operations/ Joint Venture Entities and Proportional Consolidation versus Equity Accounting

The AASB staff paper addressed the limited issue of whether the IASB should remove the option to account for joint venture entities using either equity accounting or proportional consolidation contained in IAS 31 *Financial Reporting of Interests in Joint Ventures*.

The Board decided to undertake a research project to consider improving the distinction between control of an investment and control of the underlying assets and liabilities. A number of Board Members commented that their view on whether to retain the option to use equity accounting or proportional consolidation would depend on this distinction.

The Board noted that the distinction should be based on the substance of an arrangement and not on whether a legal entity exists. However, it was also noted that the legal structure of a joint venture might have significant implications for the substance of an arrangement.

The Board noted that it may be useful to examine whether there are three types of arrangements under which a venturer controls: (a) underlying assets and liabilities; (b) interests in underlying assets and liabilities; and (c) rights to share in the activities of an entity.

The Board also decided that it would be useful to consider whether the equity method is suitable for accounting for interests in joint ventures and the usefulness of the equity accounting method in general. It was noted that any such project should examine the alternatives of fair value (under IAS 39 *Financial Instruments: Recognition and Measurement*), the expanded equity method and the gross equity method. A number of Board Members noted that the expanded equity method and the gross equity method might suffer from the same criticisms often made of proportional consolidation. Other members noted that they find the additional information provided by the expanded and gross equity methods useful, particularly when an entity conducts a large proportion of its existing operations through joint ventures. Under equity accounting, the balance sheet and income statement effectively "shrink" due to the netting that occurs in the application of the equity method and information is lost.

The Board acknowledged the work of the G4+1 in the areas of joint ventures (1999) and equity accounting (unpublished).

The Board decided that the Australian Accounting Standards Board should be responsible for the broad research project and should initially prepare a project plan, probably based on staging the project initially to cover only IAS 31 issues, with subsequent work to be scheduled on IAS 28 *Accounting for Investments in Associates*.

Share-based payment

The Board considered an initial analysis of comments received on the Exposure Draft ED 2 *Share-based Payment*, published on 7 November 2002 with a request for comments by 7 March 2003. The Board received over 230 comment letters. Respondents included investors and other users of accounts, preparers of accounts (companies and representative bodies), accounting standard-setting bodies, accountancy bodies and firms, employee share scheme consultants and others. The largest number of responses received was from preparers of accounts.

The initial analysis focused on responses to the first five questions in the Invitation to Comment. These questions relate to the proposed general principles for the recognition and measurement of transactions in which an entity receives goods or services as consideration for its shares, share options or other equity instruments. The proposals in ED 2 and the responses received are summarised below.

Scope

ED 2 proposed that all share-based payment transactions should be within the scope of the proposed IFRS (except for those covered by other standards). Of those respondents who commented on this issue, just over half generally supported the proposed scope. The majority of users of accounts, standard-setters, and accountancy bodies and firms supported the scope, while a majority of preparers of accounts and share scheme consultants did not. Of those who disagreed or had reservations, most sought exemptions for particular types of transactions. For example, some respondents sought an exemption for broad-based employee share plans; some sought an exemption for unlisted companies.

Recognition

ED 2 proposed that an entity should recognise share-based payment transactions in its financial statements, and therefore should recognise an expense when the goods or services received in such transactions have been consumed. Overall, a majority of respondents agreed with

this proposal. There was substantial support from users of accounts, standard-setters, and accountancy bodies and firms. Of those respondents who disagreed with the proposal, most disagreed either in principle, or for practical reasons (eg because, in their view, it was not possible to measure reliably the fair value of employee share options), or both.

Measurement basis

ED 2 proposed that an entity should measure equity-settled share-based payment transactions using a fair value measurement basis, ie the entity should measure the goods or services received either directly, at the fair value of the goods or services received, or indirectly, by reference to the fair value of the equity instruments granted, whichever fair value is more readily determinable. Of those respondents who addressed this issue, the majority agreed with the proposal. Some respondents who disagreed with the proposal, or who agreed with reservations, expressed concerns about measurement reliability, particularly in the case of smaller or unlisted companies.

Measurement date (direct measurement)

ED 2 proposed that, if the fair value of the goods or services received in an equity-settled share-based payment transaction is measured directly, that fair value should be measured at the date when the entity obtains the goods or receives the services. Respondents who addressed this issue were divided, with around half disagreeing with the proposal. Many of the respondents who disagreed believe that the fair value of the goods or services received should be measured at grant date.

Measurement date (indirect measurement)

ED 2 proposed if the fair value of the goods or services received in an equity-settled share-based payment transaction is measured by reference to the fair value of the equity instruments granted, the fair value of those equity instruments should be measured at grant date. The majority of respondents who addressed this issue agreed with the proposal. Of those respondents who disagreed with measurement at grant date, the most commonly cited preferred alternative measurement date was exercise date, followed by vesting date.

After considering the above analysis, the Board reviewed and approved a project plan prepared by staff, setting out a timetable and issues to be covered in finalising the IFRS. The Board plans to issue a final Standard by the end of the year.

The Board then reconsidered the general principles proposed in ED 2 for the recognition of equity-settled share-based payment transactions in the financial statements, using a fair value measurement basis, based on the comments received.

The Board tentatively agreed that the general recognition principle proposed in ED 2 should be retained in the final IFRS, ie an entity should recognise share-based payment transactions in its financial statements, and therefore should recognise an expense when the goods or services received in such transactions have been consumed. The Board also tentatively agreed that the general principle that share-based payment transactions should be measured using a fair value measurement basis should be retained in the final IFRS. It should be noted that comments by respondents advocating specific exemptions to, or departures from, these general principles will be considered at future meetings.

Furthermore, the Board tentatively agreed that, as part of the its Concepts project, the Board should expand the explanation of the definition of an expense in the IASB *Framework*, so that it is clear how that definition is applied in the context of share-based payment transactions.

Finally, the Board agreed that, having considered an initial analysis of the comment letters received, the comment letters should now be placed on the public record (except those where the respondent requested confidentiality).

Meeting dates: 2003

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

20—23 May (*note: this meeting has been extended*)

16—20 June[†], Rome, Italy

23—25 July

17—19 September; 22 and 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