BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS
IASB UPDATE
February 2003

The International Accounting Standards Board met in London on 19–21 February 2003, when it discussed:

- Business combinations (phase II)
- Convergence of accounting standards
- Employee benefits
- First-time application of IFRSs
- IFRIC
- Income statements
- Insurance contracts
- Revenue recognition.

Business combinations (phase II)

Presentation and calculation of earnings per share when an entity has one or more subsidiaries that are less than wholly owned

The Board discussed issues related to the presentation and calculation of earnings per share (EPS) when an entity has one or more less-than-wholly-owned subsidiaries. These issues arise as a result of the tentative decisions reached by the Board regarding the presentation of minority interests in the consolidated income statement and the treatment of transactions between groups of common equity-holders as equity transactions.

The Board affirmed that the tentative decisions reached on the presentation of minority interests would not affect the objective of the EPS metric, which is to calculate per share amounts for profit or loss from continuing operations and profit or loss attributable to common equity-holders of the parent. The Board also agreed to amend IAS 33 *Earnings per Share* to clarify that:

(a) The numerators used in per-share computations for profit or loss should exclude profit or loss attributable to minority interests.

(b) The control number used to determine whether securities are anti-dilutive should exclude the amount attributable to minority interests.

The Board also considered whether the numerator should be adjusted for premiums or discounts on purchases of shares from, and sales of shares to, minority interests by members of the consolidated group without a change in control. The Board agreed that the effects of such equity transactions should not be treated as adjustments to the numerator.

The Board agreed not to explore further in this project whether to provide a per-share measure of the effects of period-to-period changes in equity available to common equity-holders of the parent that result both from operations and transfers to and from minority interests.

Control obtained (or lost) through means other than an acquisition (or disposition) of equity instruments or net assets that constitute a business

The Board considered the accounting for business combination in which one entity obtains control of another entity but for which the date of obtaining control (the acquisition date) does not coincide with the date or dates of acquiring an ownership interest (the date or dates of exchange). The Board agreed that such business combinations should be accounted for similar to business combinations achieved in stages, ie at the acquisition date the carrying amount of any previous investment held by the acquirer in the acquiree should be increased to its fair value at that date, with any gains or losses on remeasurement recognised in profit or loss for the period. If the previous investment is classified as an available-for-sale financial asset, any cumulative gain or loss previously recognised in equity should be recognised in profit or loss at the acquisition date.

The Board also considered the accounting for dispositions of subsidiaries when control is lost through means other than the sale or disposition of net assets or equity instruments. The Board agreed that, consistent with its tentative decisions for derecognition of a subsidiary when control is lost through a sale of ownership interests, the gain or loss on loss of control should be recognised in profit or loss for the period, and calculated as the difference between:

(a) the carrying amount of the subsidiary's net assets in the consolidated financial statements at the date control is lost; and

(b) the sum of the carrying amount of any minority interests in the subsidiary and the fair value of any investment remaining in the former subsidiary.

Convergence

Post-employment benefits

The Board discussed whether to expand the project to a comprehensive project on post-employment benefits. It agreed that such a project was too big an undertaking at present but that a project plan should be developed for future consideration, preferably as a joint project with another standard-setter. It also agreed that the issue of whether the measurement of the plan liabilities should be based on expected final salary or current salary should not be included in the scope of the current project.

The Board agreed to replace the term 'defined benefit obligation' in IAS 19 *Employee Benefits* with 'plan liabilities'.

The Board discussed the third element of the hierarchy agreed for the asset ceiling. It noted that actuaries the staff consulted had expressed concern over the possibility of measuring reliably that element. The Board agreed that the exposure draft should state the principle

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Convergence (continued)

that an entity should recognise an asset that represents the benefit it can derive from the surplus. The exposure draft should go on to explain that:

(a) in some circumstances, the entity has control over the plan to the extent that the plan assets are in essence assets of the entity. In these cases, the benefit that can be derived from a surplus is the full amount of the surplus and the net presentation of the plan assets and plan liabilities in the entity's balance sheet is equivalent to a one-line consolidation.

(b) in other cases, the plan assets are not controlled by the entity. Rather the entity has a beneficial interest in the plan. In these cases, the entity can derive benefit from the surplus in the following ways:

   (i) through its rights to refunds and reductions in future contributions,

   (ii) through its 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), and

   (iii) through its rights not to fund future losses in the plan to the extent that the losses will be absorbed by the surplus.

The Board noted that the element (b)(iii) could, in theory, be valued in a similar way to a call option—its value depends on expectations of future changes in values of assets and liabilities in the plan. The Board agreed that the exposure draft should state that the third element would rarely be capable of reliable measurement.

The Board confirmed its previous decisions as set out in the decision summary, subject to some drafting comments.

Assets held for disposal

The Board considered an issue arising from its prior tentative decision to secure convergence with the accounting for assets classified as held for sale specified by FAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*. It noted that under US GAAP, if the eventual disposal of an asset or disposal group that is classified as held for sale would result in the recycling into income of exchange differences previously recognised in equity, the measurement of any impairment loss includes the amount of those exchange differences.

The Board agreed not to seek convergence with US generally accepted accounting principles on this matter pending its decisions on recycling in its performance reporting project.

Hyperinflationary accounting

The Board agreed to remove hyperinflationary accounting from the joint short-term convergence project. Instead, a broader project on hyperinflationary accounting would be undertaken with help from standard-setters in Argentina. It was suggested at the meeting that Mexico's assistance might also be sought.

Termination benefits

The Board elaborated its previous tentative decision to achieve convergence between the accounting for involuntary termination benefits specified by IAS 19 and that in FAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*.

It agreed that the principle underlying the requirements of FAS 146 should apply to all involuntary termination benefits, not just those that are within the scope of FAS 146. Accordingly:

(a) it confirmed its tentative decision to specify that the recognition of involuntary termination benefits should also require the communication of those benefits to the employees in addition to the criteria in IAS 19; and

(b) it agreed that when employees are (i) required to render service beyond any notification period to be entitled to the termination benefits and (ii) those benefits are not paid pursuant to any pre-existing benefit arrangement (ie they are 'one-time' benefits), those benefits should be recognised over the future service period.

First-time application of IFRSs

The Board discussed:

- hedge accounting by first-time adopters; and
- whether both approaches previously proposed are needed.

Hedge accounting

The Board discussed the treatment of hedging relationships existing at the date of an entity's date of transition to IFRSs. The date of transition to IFRSs is the beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS financial statements.

As a starting point, the Board noted that, in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*, a first-time adopter would measure all derivatives at fair value and eliminate all previously deferred gains and losses arising on derivatives. The Board then discussed whether a first-time adopter should make any further adjustments in its opening IFRS balance sheet to reflect hedging relationships existing at the date of an entity's transition to IFRSs. The Board agreed that:

(a) the opening IFRS balance sheet should not reflect a hedge relationship of a type that does not qualify for hedge accounting under IAS 39 (for example, cash instruments, most written options, many hedges of a net position, internal derivatives, hedges of interest risk in held-to-maturity investments). However, a first-time adopter may designate individual item(s) within a net position that was designated as a hedged item under previous GAAP, provided this is done no later than the date of transition to IFRSs.

(b) a first-time adopter should apply the transitional provisions of IAS 39 to other hedging relationships that existed at the date of transition to IFRSs.

Two approaches

Under the proposed IFRS, a first-time adopter would comply with the current version of each IFRS, with limited exemptions. ED 1 had proposed that a first-time adopter would be required to use each applicable exemption. However, the Board agreed in December 2002 and January 2003 that the available exemptions would not be mandatory (although the IFRS would prohibit full retrospective application of IFRSs to some aspects of hedge accounting, derecognition and estimates).

ED 1 *First-time Application of International Financial Reporting Standards* had proposed that an alternative approach would also be available. Under this alternative approach, a first-time adopter would apply IFRSs as if it had always applied IFRSs. This would require it to consider superseded versions of IFRSs if more recent versions required prospective application. In view of its earlier decision that the available exemptions would not be mandatory, the Board agreed that the alternative approach would not be needed and decided to delete it.

Next steps

The Board has now completed its redeliberation of the issues raised in the comment letters on ED 1. The staff will prepare a draft of a final IFRS. The Board expects to publish the final IFRS in the second quarter of 2003.

IFRIC

The Board was notified that the following draft documents would soon require their attention:

- Rights of use
- IAS 19 *Employee Benefits*: multi-employer plans
- IAS 19 *Employee Benefits*: plans that would be defined contribution plans but for the existence of a minimum return guarantee
- Emission rights
- Changes in decommissioning and similar liabilities
- Decommissioning funds

Additionally, the Board was informed that IFRIC was making progress on the subject of reporting linked transactions.

The Board's noted the following technical matters:

(a) the difficulties the IFRIC was having in applying an element approach to emission right schemes and that, at present, the IFRIC's intention was to employ aspects of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and to canvass the matter in a draft interpretation;

(b) possible conflict between the approach being proposed by the IFRIC for handling changes in the estimated costs of decommissioning liabilities and proposed wording for IAS 16 in the improvements project (refer separate paragraph for Board discussions of this topic);

(c) the concerns that the IFRIC had about the treatment of rights to reimbursement from de-commissioning funds under IAS 39. The IFRIC drew attention to the possible classification of these rights as originated loans and the incongruity of the resulting accounting;

(d) the development and importance of the project on rights of use. This project is considering the definition of a lease that will be more inclusive than previously. It was also noted that the IFRIC and the EITF were developing consistent views; and

(e) the Board agreed that Board members would respond to staff on issues they note in pre-ballot drafts to ensure that the IFRIC has maximum notice.

Improvements to existing IFRSs

The Board redeliberated issues raised in comments received on the following standards included in its exposure draft (ED) of proposed *Improvements to International Accounting Standards*:

- IAS 1 *Presentation of Financial Statements*
- IAS 2 *Inventories*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 10 *Events After the Balance Sheet Date*
- IAS 15 *Information Reflecting the Effects of Changing Prices*
- IAS 21 *The Effects of Changes in Foreign Exchange Rates*
- IAS 24 *Related Party Disclosures*
- IAS 33 *Earnings Per Share*.

The Board also considered some matters on IAS 16 *Property, Plant and Equipment* that were carried forward from its discussions in November 2002.

IAS 1 *Presentation of Financial Statements*

The Board considered issues raised by commentators in addition to those topics addressed in the Invitation to Comment.

Display of minority interests in the income statement

The Board agreed that amounts for both profit or loss attributable to minority interests and profit or loss attributable to equity holders of the parent entity should be presented on the face of the consolidated income statement in addition to presenting consolidated profit or loss. Further, the Board agreed not to prescribe a specific presentation format in the consolidated income statement.

Results of operating activities

The Board agreed not to require disclosure of the results of operating activities as a specific line item to be presented on the face of the income statement.

The Board instructed the staff to explain further in the Basis for Conclusions that when management chooses to present the 'results of operating activities' as an additional line item on the face of the income statement, this subtotal is clearly intended to be representative of such activities. Thus, the exclusion from this subtotal of items that are directly related to operating activities in a specific industry sector is misleading and limits the comparability of financial information.

Exemptions from restatement and disclosure requirements based on 'undue cost or effort'

The Board noted that an exemption based on 'undue cost or effort' may be interpreted as less demanding than an exemption based on 'impracticability'. The Board instructed the staff to determine when an exemption to comply with a requirement in an existing IFRS was intended to be granted on an 'undue cost or effort' basis and when it was granted only if it was impracticable to comply with the requirement.

Disclosures

The Board agreed to retain the requirement in paragraph 102(a) in the existing IAS 1 to disclose an entity's country of incorporation and the address of the registered office and to amend proposed paragraph 117(a) accordingly.

IAS 2 *Inventories*

Scope

The Board agreed to exclude from the scope of IAS 2 inventories of brokers/ traders dealing with commodities and to require such inventories to be measured at fair value and to require that changes in fair value be included in profit or loss for the period of the change.

Cost of inventories

The Board confirmed its proposals to eliminate the last-in, first-out method (LIFO) for determining the cost of inventories.

Reversal of write-downs of inventories

The Board confirmed that write-downs of inventories should be reversed when the circumstances that previously caused inventories to be written-down no longer exist and to recognise the reversal in profit or loss for the period of the reversal.

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

Voluntary changes in accounting policies and correction of errors

The Board confirmed the elimination of the allowed alternative treatment for voluntary changes in accounting policies and corrections of errors, meaning that those changes and corrections should be accounted for retrospectively with restatement of comparative periods presented as if the new accounting policy has always been in use or the error had never occurred.

Errors

The Board confirmed the elimination of the distinction between fundamental errors and other material errors and that the correction of all material errors should be accounted for retrospectively with restatement of comparative periods as if the error had never occurred.

Materiality

The Board agreed to include in IFRSs some guidance on materiality. The Board instructed the staff to research whether the relevant guidance should be included in IAS 8 or whether it would be more appropriately addressed in the context of IAS 1.

Disclosure about an IFRS that has not yet come into effect

The Board noted the staff's proposal to explain in the Basis for Conclusions the Board's objective and expectations in respect of this disclosure requirement.

Hierarchy of sources to be considered in the absence of a specific IFRS

The Board agreed to include additional guidance in the Standard regarding the application in practice of the hierarchy of sources to be considered and presented in proposed paragraph 6 of the ED.

IAS 10 *Events After the Balance Sheet Date*

The Board agreed to clarify that dividends are recognised as a liability only when they meet the criteria of a present obligation in IAS 37, ie dividends are not recognised as constructive obligations.

IAS 15 *Information Reflecting the Effects of Changing Prices*

The Board confirmed the withdrawal of this Standard and agreed to consider the issue of accounting in an inflationary environment in the context of a future project on improvements to IAS 29 *Financial Reporting in Hyperinflationary Economies*, agenda priorities permitting. The Board was told that the Argentinean Accounting Committee is providing assistance to the Board in the context of this issue.

IAS 16 *Property, Plant and Equipment*

Exchanges of non-monetary assets

The Board considered how to make operational the notion that if an entity exchanges non-monetary assets in a transaction that lacks commercial substance, it should not recognise in earnings any embedded gain on the asset it surrendered. The Board discussed which attributes of the exchanged assets, the parties exchanging the assets and the transaction terms underlie commercial substance. The Board asked the staff to consider those attributes further.

Depreciation techniques—components approach

In its review of an entity's accounting for items of property, plant and equipment that work together as a group while they are in service, the Board focused on an entity's accounting for the depreciation of, subsequent expenditure on and eventual retirement of the significant items within that group that individually have different useful lives. The Board confirmed its proposed intention for this accounting.

Depreciation—residual value

In its discussion of depreciation, the Board considered whether an entity would reverse previously recognised depreciation if an asset's revised residual value exceeds its carrying amount but not its cost. The Board asked the staff to consider this matter further.

Components of cost—dismantling, removal and site restoration

The ED of IAS 16 proposed guidance on accounting for costs to dismantle and remove an asset and restore its site. Paragraph 20A in discussing these costs states: "costs may be incurred when the asset is initially acquired or in subsequent periods, and in either case <u>are depreciated over the remainder of the asset's useful life</u>" [emphasis added].

Whilst this paragraph is not explicit on how to treat changes in such costs, it has been pointed out to the IFRIC that it can be read as requiring that all changes are added to (or deducted from) the current asset balance and reported in the income statement as an adjustment to future depreciation (ie the 'prospective' method).

In order to clarify its intention, the Board agreed to revise the wording in paragraph 20A to make clear that the depreciation method described is meant to apply only to the initial capitalisation of costs and not to amounts capitalised as a result of subsequent changes in the estimated amount of those costs.

In addition, the Board requested that the IFRIC, in considering its topic on accounting for decommissioning and similar liabilities, further discuss the measurement requirements in IAS 37, in particular, the impact of subsequent changes in the discount rate on the measurement of the liability.

IAS 21 *The Effects of Changes in Foreign Exchange Rates*

Functional currency

The Board agreed to revise the drafting of the guidance in paragraph 7 to focus more directly on the importance of the primary economic environment in which the entity operates when determining an entity's functional currency as per the definition of a functional currency.

The Board also agreed to clarify in the revised Standard that paragraph 7 is the leading paragraph and paragraphs 8 and 9 provide additional guidance.

Disclosures

The Board agreed to require disclosure of the reason for a change in functional currency, as well as the fact of a change as required in paragraph 52 of the ED.

Presentation currency

- Free choice of presentation currency

  The Board confirmed the free choice of presentation currency and agreed to clarify in the Basis for Conclusions the distinction to be made between the free choice of presentation currency according to the approach defined in the Standard and a convenience translation.

- Translation method

  The Board confirmed the translation method proposed in the ED; namely that the same method should apply when the financial statements of a foreign operation are translated for inclusion in the consolidated financial statements and when an entity, reporting on a stand-alone basis, translates its financial statements into another currency for presentation purposes.

- Translation rate of equity items

  The Board decided not to specify in the Standard the translation rate for equity items.

Exchange differences resulting from a severe devaluation or depreciation of a currency against which there is no means of hedging

The Board confirmed the requirement to recognise such exchange differences in profit or loss in the period they arise.

Goodwill and fair value adjustments arising on acquisition of a foreign operation

The Board confirmed the requirement to treat such items as part of the assets and liabilities of the acquired entity, ie to measure these items in the functional currency of the acquired entity, and to translate these items at the closing rate, removing the option to treat these items as assets and liabilities of the parent/acquirer.

Transitional provisions

The Board agreed that the requirement to treat goodwill and fair value adjustments of assets and liabilities arising on acquisition of a foreign operation as assets and liabilities of the foreign operation should be applied prospectively to acquisitions occurring after the effective date for implementation of the revised IAS 21, but to encourage retrospective application of this change.

The Board confirmed that all other changes resulting from the revisions to IAS 21 are subject to the provisions in IAS 8 with respect of the adoption of a Standard, meaning that the changes in accounting policies should be applied retrospectively.

IAS 24 *Related Party Disclosures*

Key management compensation

The Board decided to include in the revised Standard a requirement to disclose key management compensation. The Board instructed the staff to include guidance in the Standard to define 'compensation' of key management personnel.

Disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or a wholly owned subsidiary

The Board agreed to require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or a wholly owned subsidiary. There would be no exemption to this requirement when these financial statements are made available or published with the consolidated financial statements for the group to which that entity belongs.

Disclosure of names of related parties

The Board agreed to include in proposed paragraph 14 in the ED a requirement to disclose the name of the ultimate controlling party, if different from the parent.

IAS 33 *Earnings per Share*

Year-to-date calculation of diluted earnings per share

The Board discussed the fact that the proposed calculation of year-to-date diluted earnings per share is affected by the frequency of interim reporting and that two entities with identical results would have different year-to-date earnings per share if they did not report on the same interim basis. The Board stated that it could not mandate the frequency of interim reporting and tentatively agreed to withdraw the proposed approach to the year-to-date calculation of diluted earnings per share whereby:

(a) the number of potential ordinary shares is a year-to-date weighted average of the number of potential ordinary shares included in each interim diluted earnings per share calculation;

(b) the number of potential ordinary shares is computed using the average market price during the interim periods reported upon; and

(c) contingently issuable shares are weighted for the interim periods in which they were included in the computation of diluted earnings per share.

The Board noted that this will create divergence with US GAAP and directed the staff to work with the FASB to determine whether this could be added to the short-term convergence project.

Contracts that may be settled either in ordinary shares or in cash, at the issuer's option

The Board discussed including or excluding contracts that may be settled either in ordinary shares or in cash, at the issuer's option, in determining the number of potential ordinary shares in the diluted earnings per share calculation. The ED proposed making this determination based on a rebuttable presumption that the contracts will be settled in shares. The Board noted that the stated objective of diluted EPS is to provide a measure of the interests of each ordinary share in the profit or loss of the entity for the reporting period while giving effect to all dilutive potential ordinary shares outstanding during the period. It concluded that the notion of a rebuttable presumption is inconsistent with that objective.

The Board tentatively agreed to withdraw the notion of a rebuttable presumption. Consequently, all financial instruments or other contracts that may result in the issue of ordinary shares of the reporting entity at the option of the issuer or the holder, are potential ordinary shares of the entity.

The Board noted that this will create divergence with US GAAP and again directed the staff to work with the FASB to determine whether this could be added to the short-term convergence project.

Compulsorily convertible securities

The Board discussed whether to add guidance to the ED stating that the shares that will be issued upon the conversion of a compulsorily convertible security should be included in the weighted average number of ordinary shares used in the calculation of basic earnings per share from the date the contract is entered into. The Board noted that, unlike forward contracts to issue shares, the entity receives the consideration for the shares when the convertible security is issued. The Board tentatively agreed that such shares should be included in the weighted average number of ordinary shares used in the calculation of basic earnings per share from the date the contract is entered into.

Presentation of parent-only earnings per share

The Board discussed the proposed removal of the present IAS 33 paragraph 2, which states that when both parent and consolidated financial statements are presented, the information need be presented only on the basis of consolidated profit or loss. The Board directed the staff to develop the analysis further.

Effective date

The Board agreed that the same implementation date would apply to all the Standards revised in the Improvements project. The revised Standards would be mandatory for annual financial statements covering periods beginning on or after 1 January 2005 (not 2003 as proposed in the ED). Earlier application (after publication of the revised Standards) would be encouraged.

Next steps

The Board will discuss at a subsequent meeting outstanding issues on:

- IAS 16 with respect to exchanges of non-monetary assets.
- IAS 17 with respect to the interaction between IAS 17 and IAS 40 *Investment Property* when a property interest held under a long-term operating lease is accounted for as an investment property under IAS 40.
- IAS 28 with respect to proposed guidance for circumstances where a parent's and associate's financial year-ends are not coterminous.

Income statements

The Board discussed whether and how an operating profit line subtotal should be defined in the income statement. The following four alternative methods were discussed.

(a) Redefine the income before remeasurements column to include particular items transferred from the remeasurements column. Candidates for transfer would include impairments of inventory and fixed assets, as well as remeasurement of short-term provisions.

(b) Retain the existing definitions of the columns, but allow entities a free choice over the allocation of items to rows, thereby enabling the display of items either above or below an entity-designated operating profit line.

(c) Introducing an 'other operating' category, to be reported within business activities, after operating and before financial items. This category would include only items identified by the Board. Entities would be able to take items out of the 'other operating' category and report them within operating, but transfers in the other direction would be disallowed. The subtotal 'operating profit' would be required and would include all items in the operating category.

(d) As a hybrid of (b) and (c), particular items designated by the Board could be shown in an entirely separate category(s) at the bottom of the income statement, leaving all residual items within an operating category.

The Board voted in favour of Option (c), although it did not settle which specific items should be included in the other operating category. Items under consideration include: revaluation of property, plant and equipment and intangible assets; property, plant and equipment disposal gains and losses; investment property fair value changes; foreign exchange gains and losses on net investments; goodwill impairment and gains recognised in a business combination (negative goodwill).

The Board decided that income from associates should be reported in the financial assets category within business profit.

The Board approved proposals to conduct field visits to aid the development of an exposure draft – in particular, to seek input on the Board's tentative decisions from financial statement users and from reporting entities.

Financial activities

The Board discussed the following three alternative approaches to income statement formats for those entities whose primary activities are financial:

(a) make no exceptions to the general model and treat financial institutions like all other entities;

(b) allow the categories to be displayed in a different order, but otherwise leave the definitions of the categories unchanged;

(c) redefine the categories (in particular, financing) for the special case of financial institutions.

The Board expressed an initial preference for Option (a) or Option (b), primarily due to concerns that it would be impossible to define financial institutions precisely enough to allow Option (c) to be implemented consistently. The Board identified a possible need for subtotals within categories – for example, enabling financial institutions to categorise different types of expense on financial liabilities.

Insurance contracts

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

- Definition of insurance contract
- Embedded derivatives
- Unbundling
- Derecognition
- Acquisition of insurance contracts in business combinations and portfolio transfers
- Discretionary participation features
- Disclosure principles

Definition of insurance contract

The proposed definition of an insurance contract requires that the insurer accept significant insurance risk. The Board confirmed that:

(a) the test for insurance risk is carried out contract by contract, rather than in aggregate for a book of similar contracts.

(b) insurance risk is significant if there is a reasonable possibility that an event affecting the policyholder will cause a significant change in the present value of the insurer's net cash flows arising from that contract. In other words, if a significant loss for the insurer is possible in one foreseeable scenario, the insurance risk is significant.

(c) if the insurer can foresee at inception that the probability or present value of a significant loss may increase over time, the contract is an insurance contract from inception, even if the expected (ie probability-weighted average) present value of the loss is very small at that date. In other words, if an event can occur that makes insurance risk significant, the contract is an insurance contract from inception.

It follows that if a contractual death benefit is more than the amount payable on surrender or maturity, the contract is an insurance contract unless the additional death benefit is insignificant. Similarly, an annuity contract that pays out regular sums for the rest of a policyholder's life is an insurance contract, unless the aggregate life-contingent payments are insignificant.

Embedded derivatives

Under IAS 39, an embedded derivative is required to be separated from the host contract and measured at fair value if specified conditions are met. The Board agreed in November 2002 that an embedded derivative need not be separated from a 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). However, Board members identified in November 2002 the need to link this notion more closely to the insured event that creates significant insurance risk. At this meeting, the Board agreed to do this by providing that an entity need not separate an embedded derivative that itself meets the definition of an insurance contract.

Two types of components embedded in some insurance contracts (guaranteed annuity options and guaranteed minimum death benefits) meet the proposed definition of an insurance contract. Thus an issuer need not separate them and measure them at fair value, even though they create significant exposures to interest risk and market risk. It follows from earlier decisions (see *IASB Update* October 2002) that an insurer would measure these components at fair value if its existing accounting policies so require, or if it introduces a new accounting policy that results in more relevant and reliable financial statements.

The Board agreed on the need for prominent disclosures about exposures under guaranteed annuity options and guaranteed minimum death benefits, given that fair value measurement of these derivatives would not be required in phase I.

Unbundling

The Board agreed tentatively in November 2002 that an insurer should unbundle deposit-like components from an insurance contract if the cash flows from the insurance component do not affect the cash flows from the deposit-like component. The Board confirmed that this proposal is not intended to require an insurer to unbundle the surrender value in a traditional life insurance contract. The staff will develop wording to implement this.

The Board also agreed that an insurer need not separate an option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate) even if the exercise price differs from the carrying amount of the host insurance liability.

Derecognition

The Board agreed that:

(a) the derecognition requirements for an insurer's insurance liabilities should be the same as those for financial liabilities. In other words, an insurer should remove an insurance liability (or a portion of an insurance liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled, or expires.

(b) Phase I should not address derecognition of an insurer's insurance assets (the rights that it holds under insurance contracts).

Acquisition of insurance contracts in business combinations and portfolio transfers

The Board agreed that:

(a) Phase I should not exempt insurance liabilities and insurance assets (and related reinsurance) from the long-standing general requirement for an acquirer to fair value assets and liabilities assumed in a business combination. However, phase I should permit, but not require, an expanded presentation that splits the fair value of acquired insurance contracts into two components:

  (i) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it originated; and

  (ii) an intangible asset, representing the fair value of the rights and obligations associated with the closed book of insurance contracts assumed, to the extent that the liability does not already reflect that fair value. Phase I should not include guidance on how to determine that fair value.

(b) Phase I should permit an insurer acquiring a block of existing insurance contracts to use a similar treatment.

(c) Intangible assets arising from the rights and obligations associated with the closed book of insurance contracts assumed in a business combination or portfolio transfer should be excluded from the scope of IAS 36 *Impairment of Assets*, as they would be covered by a proposed loss recognition test under IAS 37 (see *IASB Update* October 2002). Furthermore, that loss recognition test should include cash flows from related investments if (and only if) the underlying measurement basis for those assets also includes those cash flows.

(d) These intangible assets should also be excluded from the scope of IAS 38 *Intangible Assets* and their subsequent measurement should be consistent with the measurement of the related insurance liability. However, IAS 36 and IAS 38 should still apply to customer relationships that reflect the expectation of renewals and repeat business outside the closed book of existing contracts and customer lists.

Discretionary participation features

The Board continued its discussion on investment contracts that contain both a fixed element and a discretionary participation feature (see *IASB Update* January 2003). The Board agreed that:

(a) an insurer should measure such contracts at no less than the amortised cost of the fixed element (as determined under IAS 39).

(b) phase I would not specify a particular method of accounting for the discretionary participation feature in investment contracts as the Board will review the treatment of insurance contracts containing such features in phase II. However, phase I would not permit an insurer to classify unallocated surplus arising from discretionary participation features as an intermediate category that is neither liability nor equity.

(c) phase I would not address the implications of timing differences between (i) the basis for determining the unallocated surplus arising from discretionary participation features and (ii) profit or loss reported under IFRSs.

Disclosure principles

The Board agreed three disclosure principles:

Disclosure to identify and explain the insurance-contract-related amounts reported in the balance sheet, income statement and cash flow statement (principle 1) would involve disclosure about:

(a) accounting policies for insurance contracts and related assets, liabilities, income and expense.

(b) the amounts of key assets, liabilities, income, expense and cash flows related to insurance contracts.

(c) significant assumptions, as well as other sources of measurement uncertainty, and changes in assumptions.

(d) changes in insurance liabilities and, if any, deferred acquisition costs and intangible assets relating to insurance contracts acquired in business combinations or portfolio transfers.

Disclosure that helps users understand the estimated amount, timing and uncertainty of future cash flows from insurance contracts (principle 2) would involve disclosure about:

(a) the terms and conditions of insurance contracts that have the most significant effect on the amount, timing and certainty of future cash flows.

(b) segment information required by IAS 14 *Segment Reporting* (if the insurer issues equity or debt securities that are publicly traded). Some Board members expressed a preference for extending the scope of IAS 14 to all insurers and deposit-taking institutions. The Board decided to address this question in its project on deposit-taking, lending and securities activities.

(c) the insurer's objectives in managing risks arising from insurance contracts and its policies for mitigating risk (including asset/liability management).

(d) insurance risk (reported both gross and net of reinsurance, and including sensitivity analysis, information about concentrations of insurance risk and details of actual claims compared with previous estimates [claims development], as well as related lapse risk and expense risk). The disclosure about claims development should go back to the period in which the earliest material incurred claim still outstanding arose, but need not go back more than ten years. It follows that an entity issuing an insurance contract need not disclose this information if claims typically settle within one year. Disclosure would not be required of loss 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).

(e) interest risk and credit risk.

For disclosures of the fair value of insurance assets and insurance liabilities (principle 3), the Board acknowledges that insurers will need time to develop systems. Furthermore, the Board has yet to resolve some conceptual and practical aspects of fair value measurements for insurance liabilities. Therefore, the Board agreed that an insurer:

(a) need not disclose these fair values for dates before 31 December 2006.

(b) should disclose information about the principal characteristics of the underlying assets and liabilities that are pertinent to their fair value from 31 December 2005, although the Board accepts that an insurer may not yet be able to disclose the fair value itself.

For example, in financial statements for 31 December 2005 an insurer would disclose fair value at that date, or information relating to fair value if it cannot yet determine fair value. It need not disclose fair value at 31 December 2004. In its 2006 financial statements, the insurer would disclose fair value at 31 December 2006 and information relating to fair value at 31 December 2005.

Next steps

The Board plans to complete its substantive discussions for phase I by addressing the following issues in March 2003:

- cancellation and renewal rights held by policyholders (follow-up of discussion in January)
- reinsurance
- disclosure (follow-up of February meeting)
- insurance against credit risk and financial guarantees (follow-up of a scope issue discussed in October 2002)
- transition, effective date and consequential amendments.

The Board aims to publish an Exposure Draft for phase I around the end of second quarter of 2003.

Revenue recognition

The Board discussed the advantages and disadvantages of the 'liability extinguishment view' and the 'broad performance view' of revenue. These views (described below) are concerned with the amount of revenue that an entity should recognise—ie what share of consideration received from customers should be recognised as revenue? They do not address the timing of revenue recognition.

Under the 'liability extinguishment view', revenues arise as liabilities to customers are extinguished other than by legal assumption of the obligations by a third party. Under the 'broad performance view', revenues arise when the reporting entity extinguishes liabilities to customers by performing those obligations itself. These views report different amounts of revenue when a third party is contracted to perform the obligations to customers but without that obligation being legally assumed by the third party.

In comparing these views, the Board focused on the qualitative characteristics of relevance, comparability and reliability, and the constraint that the costs of information reported should not exceed its benefits.

The Board's deliberations on these views of revenue are incomplete. However, the Board tentatively agreed that:

(a) in assessing the relevance of revenues reported, the ability of users to identify market share, volume of activity and trading margins should be considered in addition to the usefulness of reported revenue for assessing profitability.

(b) assessments of the comparability of the information reported under each view depend on whether an entity's performance should be the driver of how much revenue to report.

(c) under the 'liability extinguishment view', an entity can write contracts with customers and third parties in a way that produces different revenue recognition outcomes, even though the entity's performance may be substantially the same in each case.

(d) both views of revenue give rise to practical difficulties. Under the 'broad performance view', when a third party agrees to perform an obligation to a customer without legally assuming the obligation, it would be necessary to measure the value of the performance guarantee because that would be the entity's only source of revenue. In addition, the Board would need to define 'performance' and develop potentially complex guidance on that notion. Under the 'liability extinguishment view', it would be necessary to define 'primary obligor', 'secondary obligor' and 'legally released'.

The Board asked the staff to prepare papers on the following subjects before it chooses its preferred view of revenue:

(a) definitions of 'performance' and 'primary obligor'.

(b) whether sales of goods and services would be treated consistently under the 'broad performance view'.

(c) a comprehensive overview of the costs of applying each view.

The Board asked the staff to develop a case study illustrating the application of the 'gross inflow view', the 'liability extinguishment view', the 'value added view' and the 'broad performance view'. In addition, the Board asked the staff to prepare papers exploring broader notions of performance than the 'broad performance view' described in the current agenda papers.

The Board also discussed two different interpretations of the 'liability extinguishment view', as illustrated by certain cases from EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*. Under Interpretation 1, there is only one reporting entity (the 'primary obligor') the customer looks to for satisfaction of what it is owed under the contract, even if the contract involves more than two parties. Thus, the primary obligor would recognise revenue on a gross basis for the contract with the customer. Interpretation 2 focuses on each obligation arising from a customer contract, rather than on identifying a primary obligor for the contract as a whole. Under Interpretation 2, different entities might be identified as the obligors for different obligations specified in the contract. The Board tentatively agreed that Interpretation 2 should be used to describe the 'liability extinguishment view'

Meeting dates: 2003

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

Week of 10 March—public roundtables on IAS 32 and IAS 39§

10 and 11 March—Brussels

12–14 March—London

19—21 March

§ For further details visit *www.iasb.org.uk*