

The International Accounting Standards Board met in London on 20-23 January 2004, when it discussed:

- Business combinations
- Disposal of non-current assets and presentation of discontinued operations
- Financial instruments – hedging
- IFRIC issues
- Insurance contracts
- Leases
- Post-employment benefits
- Revenue recognition

Business Combinations (phase I)

Board members recently completed their reviews of the pre-ballot drafts of IFRS 3 *Business Combinations*, IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*. As a result of reviewing those pre-ballot drafts, Board members identified several issues for reconsideration. The Board discussed those issues at this meeting.

IFRS 3

The Board considered three issues related to IFRS 3.

First, the Board decided that the 'objective' should set out both the broad objective of the IFRS and the IFRS's overarching requirement.

The second issue was how an acquirer should account for any adjustments to the provisional values previously determined for the cost of the combination, the assets acquired, or the liabilities or contingent liabilities assumed when it completes the initial accounting for a business combination.

The Board decided that an acquirer should recognise any adjustments to provisional values as a result of completing the initial accounting from the acquisition date by:

- calculating the carrying amount of an identifiable asset, liability or contingent liability that is recognised or adjusted as a result of completing

the initial accounting as if its fair value at the acquisition date had been recognised at that date.

- adjusting goodwill at the acquisition date by an amount equal to the adjustment to the fair value at the acquisition date of the identifiable asset, liability or contingent liability being recognised or adjusted.
- presenting comparative information for the periods before the initial accounting is complete as if the initial accounting had been completed at the acquisition date. This would include any additional depreciation, amortisation or other profit or loss effect recognised as a result of completing the initial accounting.

The third issue was whether an entity that previously recognised goodwill as a deduction from equity should recognise that goodwill in profit or loss when it disposes of all or part of the business to which that goodwill relates or when a cash-generating unit to which the goodwill relates becomes impaired.

On this issue, the Board decided that an entity should be prohibited from recognising such goodwill in profit or loss when it disposes of all or part of the business to which that goodwill relates or when a cash-generating unit to which the goodwill relates becomes impaired.

IAS 36

The Board considered three issues related to IAS 36.

The first issue was whether the period acquirers have to complete the initial allocation to cash-generating units of newly acquired goodwill should be the same as the period to complete the initial accounting for a business combination.

The Board concluded that acquirers should be allowed a longer period to complete the goodwill allocation because that allocation generally cannot be performed until the initial accounting for the combination is complete. Therefore, the Board decided to proceed with its previous decision to require an acquirer:

- to complete the initial accounting for a business combination within twelve months of the acquisition date; and
- to complete the initial allocation of goodwill acquired in a business combination before the end of the first annual period beginning after the acquisition date.

The second issue was the distinction between 'costs to service the asset' and 'costs for day-to-day servicing of the asset' in the following two requirements in IAS 36:

- (a) the requirement to exclude from the future cash flows used in determining an asset's value in use any future cash inflows or outflows expected to arise from future costs to add to, replace part of, or service the asset.
- (b) the requirement to include in those future cash flows any future costs necessary for the day-to-day servicing of the asset.

On this issue, the Board observed that the intended meaning of 'costs to service the asset', and the distinction between that phrase and 'costs for day-to-day servicing of the asset' can be inferred from the discussion in paragraphs 12-14 of IAS 16 *Property, Plant and Equipment*. In particular, in IAS 36 'costs to service the asset' is intended to mean the costs referred to in IAS 16 paragraph 14 that arise from major inspections. In other words, expected future costs for major inspections are excluded from value in use calculations,

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Business combinations (phase I) (continued)

whereas expected future costs necessary for the day-to-day servicing of assets are included. Therefore, the Board decided to amend the requirement at (a) above to require future cash flows used in measuring an asset's value in use to exclude any future cash inflows or outflows expected to arise from future costs to add to or replace part of, or for major inspections of, the asset. A cross-reference to the more detailed discussion in IAS 16 would be added.

The third issue was the level at which acquired goodwill should be tested for impairment.

The Board had previously concluded that, for the purpose of impairment testing, goodwill acquired in a business combination should, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated should represent the lowest level within the entity at which the goodwill is monitored for internal management purposes. However, each unit or group of units should not be larger than a segment based on either the entity's primary or the entity's secondary reporting format determined in accordance with IAS 14 *Segment Reporting*. At this meeting, the Board agreed to clarify the wording relating to the recognition that a unit or group of units to which goodwill is allocated for the purpose of impairment testing may not coincide with the level at which goodwill is allocated in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates* for the purpose of measuring foreign currency gains and losses. For example, if an entity is required by IAS 21 to allocate goodwill to relatively low levels for the purpose of measuring foreign currency gains and losses, it is not required to test the goodwill for impairment at that same level unless it also monitors the goodwill at that level for internal management purposes.

IAS 38

The Board considered two issues related to IAS 38.

The first issue was, for finite-lived intangible assets, whether it should retain the requirement currently in IAS 38 that the residual value of an intangible asset is assumed to be zero unless:

- (a) there is a commitment by a third party to purchase the asset at the end of its useful life; or
- (b) there is an active market for the asset and:
 - (i) residual value can be determined by reference to that market; and
 - (ii) it is probable that such a market will exist at the end of the asset's useful life.

On this issue the Board observed that the definition of residual value requires that it be estimated as though an asset were of the age and in the condition expected at the end of its useful life. Therefore, if the useful life of an intangible asset is shorter than its economic life because the entity expects to sell it before the end of that economic life, the asset's residual value would not be zero, irrespective of whether the conditions in (a) and (b) above are met.

Nevertheless, the Board observed that the IASC's inclusion in IAS 38 of the requirement that the residual value of an

intangible asset is assumed to be zero unless the specified criteria are met was a means of preventing entities from circumventing the requirement to amortise all intangible assets. Not retaining this requirement for finite-lived intangible assets would provide a means of circumventing the requirement to amortise intangible assets with finite lives. In other words, by asserting that the residual value of a finite-lived intangible asset was equal to or greater than the asset's carrying amount, an entity could avoid amortising the asset, even though its useful life is finite.

The Board concluded that it should not, as part of the Business Combinations project, modify the criteria for permitting an intangible asset's residual value to be other than zero. However, the Board agreed to refer this issue to the Australian Accounting Standards Board (AASB) for consideration as part of the research project on intangible assets that the AASB is undertaking on the IASB's behalf.

The second issue was whether, if an intangible asset acquired in a business combination is separable but only together with a related tangible or intangible asset and the fair values of those assets cannot be individually determined, an acquirer should be:

- (a) permitted to recognise the assets as a single asset separately from goodwill but only if the assets have similar useful lives; or
- (b) required to recognise the assets as a single asset.

On this issue, the Board decided that if the fair values of the assets cannot be individually determined, an entity should be required to recognise those assets as a single asset. This ensures that such assets are not inappropriately subsumed within goodwill.

Next steps

The Board has concluded its redeliberations of ED 3 and the proposed amendments to IASs 36 and 38. The staff will now prepare a ballot draft for the Board, with the intention of publishing the Standards in March 2004.

The staff asked whether any Board members were likely to dissent from any of the Standards. Two Board members indicated that they would dissent from IFRS 3, primarily on the basis that goodwill acquired in a business combination is not amortised. Three Board members indicated that they would dissent from IAS 36, citing the goodwill impairment test. One member indicated that he would dissent from IAS 38, primarily over the recognition of intangible assets acquired in a business combination.

Disposal of non-current assets and presentation of discontinued operations

Analysis of comments received on ED 4

The Board discussed an analysis of comments received in response to questions 5-9 in the Invitation to Comment on the ED.

The Board also discussed whether the Standard should include any transitional provisions.

Revalued assets

ED 4 proposed that, for revalued assets, impairment losses arising from the write-down of assets (or disposal groups) to fair value less costs to sell (and subsequent gains) should be treated as revaluation decreases (and revaluation increases) in accordance with the standard under which the assets were revalued, except to the extent that the losses (or gains) arise from the recognition of costs to sell. Costs to sell and any subsequent changes in costs to sell would be recognised in profit or loss.

Several respondents disagreed or expressed concerns with the proposal. In particular, they objected to the proposed accounting for revalued assets in a disposal group.

The Board considered whether assets that were revalued before being classified as held for sale should (i) continue to be carried at a current value (ie fair value less costs to sell) after classification as held for sale, or (ii) treated in the same way as assets that were not previously revalued (ie at the lower of carrying value at reclassification and fair value less costs to sell).

The Board observed that classification as held for sale results in a new measurement basis. The Board also noted that continuing to revalue some (but not all) non-current assets after classification as held for sale adds considerable complexity to the IFRS. The Board tentatively decided to amend its proposals for non-current assets that were revalued before being classified as held for sale so that:

- non-current assets that were revalued under IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* are measured after being classified as held for sale at the lower of their carrying amounts and fair value less costs to sell, ie revaluation should cease when such assets are classified as held for sale.
- non-current assets that used the fair value model in accordance with IAS 40 *Investment Property* and IAS 41 *Agriculture* are excluded from the measurement requirements of the IFRS and would continue to be measured in accordance with IAS 40 and IAS 41. The presentation requirements of the IFRS would apply.

Removal of the exemption from consolidation for subsidiaries acquired and held exclusively with a view to resale

ED 4 proposed a consequential amendment to IAS 27 *Consolidated and Separate Financial Statements* to remove the exemption from consolidation for subsidiaries acquired and held exclusively with a view to resale.

Respondents were divided on this issue. In particular, those who disagreed questioned the relevance of the information given and expressed cost/benefit concerns. Some respondents also requested an exemption for specific industries.

After discussing the responses to its proposal, the Board reconfirmed it, noting that:

- all assets that are classified as held for sale should be treated in the same way.
- consolidation of controlled entities should reflect conditions that exist at the balance sheet date and not the intention of the controlling party (ie assets controlled through subsidiaries should be treated in the same way as assets held directly).
- the proposal converges with SFAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*.

The Board decided to clarify what is meant by ‘consolidation’ of such subsidiaries, that an entity applies the presentation required for assets (and disposal groups) held for sale, rather than the “normal” line-by-line consolidation presentation.

Presentation of non-current assets held for sale

ED 4 proposed that non-current assets classified as held for sale, and assets and liabilities in a disposal group classified as held for sale, should be presented separately in the balance sheet. The assets and liabilities of a disposal group classified as held for sale should not be offset and presented as a single amount.

Almost all respondents agreed with the proposed presentation. The Board reconfirmed its proposal.

The Board considered whether to specify how disposal gains and losses and impairment losses relating to continuing operations should be presented in the income statement and agreed that this issue should be considered in its project on reporting comprehensive income.

Classification as a discontinued operation

ED 4 proposed that a discontinued operation should be a component of an entity (ie operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity) that either has been disposed of, or is classified as held for sale, and

- the operations and cash flows of that component have been, or will be, eliminated from the ongoing operations of the entity as a result of its disposal, and
- the entity will have no significant continuing involvement in that component after its disposal.

A majority of respondents disagreed with the proposal. In particular, they questioned whether the proposed definition of a discontinued operation would result in decision-useful information and expressed cost/benefit concerns.

The Board considered these objections and decided that it wished to distinguish between the disposal of *assets* and the discontinuance of *an operation*.

The Board asked the staff to explore a definition of an operation, to see how the Board’s intention might be clarified. The Board will discuss this issue again at its February 2004 meeting.

Presentation of a discontinued operation

ED 4 proposed that the revenue, expenses, pre-tax profit or loss of discontinued operations and any related tax expense should each be presented separately on the face of the income statement. An alternative approach would be to present a single amount, profit or loss after tax, for discontinued operations on the face of the income statement with a breakdown of the components in the notes.

A majority of respondents preferred the alternative approach. The Board observed that its discussions in the project on reporting comprehensive income had previously concluded that the results of discontinued operations should be presented as a single item because the gross components give little information with respect to future income. Given the delay to the project on reporting comprehensive income, the Board decided to allow preparers an option between the proposed presentation and the alternative presentation as a single amount on the face of the income statement with a breakdown given in the notes.

The Board considered whether the presentation of discontinued operations should be extended to an entity's segment information. The Board decided that such disclosure would be useful for users and agreed to require presentation of discontinued operations on a segment level, if applicable.

Transitional provisions

ED 4 proposed that an entity should apply the IFRS retrospectively in its annual financial statements beginning on or after 1 January 2005 (earlier application was to be encouraged). Some respondents questioned the proposed transitional provisions because retrospective application could be burdensome and some of the necessary information might not be available.

The Board noted that the definition of a discontinued operation differs from IAS 35 *Discontinuing Operations* and might be different under an entity's previous GAAP. It agreed that the restatement of an entity's comparative financial statements could be burdensome, particularly if the entity published interim financial statements. The Board also noted that restatement of comparative information for non-current assets (and disposal groups) classified as held for sale could require the use of hindsight.

Therefore, the Board therefore concluded that the requirements of the final IFRS relating to the classification as and measurement of non-current assets (and disposal groups) held for sale should be applied prospectively. However, entities should be permitted to apply the requirements of the IFRS to all assets held for sale and discontinued operations occurring after any date before the effective date of the IFRS, provided the valuations and other information needed to apply the IFRS to assets determined to be held for sale or operations discontinued in prior periods were obtained at the time those events were initially accounted for.

Fair value hedge accounting for a portfolio hedge of interest rate risk

Core deposits

The Board discussed how to include liabilities with a demand feature (referred to below as 'core deposits') in a portfolio hedge of interest rate risk. The Exposure Draft proposed that a core deposit cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment. The Basis for Conclusions set out an alternative view, namely that core deposits could be included in a portfolio hedge of interest rate risk based on their expected maturity on a portfolio basis.

The Board noted that this issue is related to the issue of how to measure a core deposit at fair value. In particular, it interrelates with the requirement in IAS 39 *Financial Instruments: Recognition and Measurement* that the fair value of a liability with a demand feature is not less than the amount payable on

demand, discounted from the first date that the amount could be required to be paid. This requirement applies to all liabilities with a demand feature, not only to those included in a macro hedge.

The Board noted that, when managing risk, many entities schedule core deposits based on the expected repayment date of the total balance of a portfolio of accounts. This scheduling includes expected rollovers or replacements of existing deposits by new deposits. However, the Board noted that such expected future new deposits are forecast transactions and, as such, do not qualify for fair value hedge accounting under IAS 39.

The Board considered an alternative approach under which a core deposit could be included in a macro hedge based on the expected repayment date of the *existing balance*, ignoring any rollovers or replacements of existing deposits by new deposits. The Board noted that:

- This approach would imply a much earlier expected repayment date than is generally assumed for risk management purposes.
- This approach implies that the *fair value* of the core deposit should also reflect the expected repayment date of the existing balance. This could give rise to a difference on initial recognition between the amount deposited and the fair value recognised in the balance sheet. The Board discussed whether this difference represents (a) the option that the depositor has to withdraw the deposit, (b) the entity's liability to service the deposit for no future consideration, or (c) a gain. It noted that if it were to require such differences to be recognised, this would apply to all such deposits, not only to those included in a macro hedge. Such a requirement would represent a significant change to present practice.
- Regardless of whether fair value of a deposit at the date at the date of initial recognition equalled the amount deposited, a fair value macro hedge based on such an expected repayment date is likely to be ineffective. This is because core deposits typically pay interest at a rate that is significantly lower than that being hedged (eg the deposits may pay interest at zero or at very low rates, whereas the interest rate being hedged may be LIBOR or a similar benchmark rate). Hence the fair value of the core deposit will be significantly less sensitive to interest rate changes than that of the hedging instrument.

Finally, the Board noted that the question of how to fair value a core deposit is closely related to issues being debated by the Board in other projects, including Insurance (phase II), Revenue Recognition and Measurement. Its discussions in these other projects are continuing and it would be premature to reach a conclusion in the context of macro hedging without considering the implications for these other projects.

In the light of the above discussion, the Board tentatively decided:

- not to reconsider the proposal in the ED that a core deposit cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.
- not to change paragraph 49 of IAS 39, which states: "The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid."

The Board noted that, depending the outcome of its discussions in other projects (principally Insurance (phase II), Revenue Recognition and Measurement), it might reconsider these decisions at some time in the future.

The Board also noted that entities that are unable to apply fair value hedge accounting to their macro hedges may use IAS 39's provisions for cash flow hedge accounting (eg by designating a hedge of associated variable rate assets). Such entities may choose to present gains and losses on cash flow hedges that are recognised in equity separately from other components of equity.

Designation and Effectiveness

The Board discussed how to designate the hedged item and to measure ineffectiveness in a portfolio hedge of interest rate risk. The Board considered points raised by respondents to the Exposure Draft, including the following issues.

- Whether to permit the designation of a net position as the hedged item. The Board tentatively decided to retain the proposal in the ED that the net position cannot be designated as the hedged item.
- Whether the Board should specify any method for designating the hedged item and measuring effectiveness. The Board tentatively decided that when the hedged item is designated as an amount, the final Standard should specify a method for designating the hedged item and measuring ineffectiveness.
- Whether to require a method of designation under which ineffectiveness arises both when changes in interest rates (and associated changes in prepayment rates) cause an entity to become over-hedged and when such changes cause it to become under-hedged. The Board tentatively confirmed the exposure draft's proposal to require such a method of designation, ie to require that the change in the value of a hedged prepayable asset that is attributable to interest rates should include the effect that interest rates have on prepayment rates.
- How to implement the tentative decision noted in the previous point. The Board tentatively decided that:
 - if an entity can reliably measure the change in the fair value of the entire asset or liability that is attributable to changes in interest rates (including the effect that a change in interest rates has on prepayment rates) it should use this method to measure the effectiveness of the hedge.
 - in other cases, the entity should use the percentage method proposed in the Exposure Draft.
- The Board considered whether to clarify that when prepayment estimates change because of factors other than changes in interest rates, no ineffectiveness arises. The Board asked the staff to draft proposed wording for inclusion in the Standard for it to consider.

The Board directed the staff to ensure that a discussion of the rationale for these decisions is included in the Basis for Conclusions.

IFRIC issues

The Board received an oral report from the Chairman of the International Financial Reporting Interpretations Committee on the IFRIC's recent activities and projects likely to come before it in the near future. New issues were noted, particularly that the IFRIC is likely to consider, on an urgent basis, an issue related to the presentation of members' shares in co-operative banks (an issue related to IAS 32 *Financial Instruments: Disclosure and Presentation*). The financial reporting of venture capital entities' investments (an issue related to IAS 27

Consolidated and Separate Financial Statements) is also likely to come to the IFRIC.

Insurance Contracts (phase I)

The Board completed its discussion of the comment letters received on ED 5 *Insurance Contracts*, with specific reference to:

- Financial assets backing insurance contracts
- Property backing insurance contracts
- Investment contracts
- Discretionary participation features
- Scope – financial guarantees and credit insurance
- Embedded derivatives
- Changes in accounting policies
- Disclosure
- Minor issues
- Transition and effective date.

The Board also discussed the deposit floor for investment contracts (see separate summary of the Board's discussion on *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*).

Financial assets backing insurance contracts

The Board continued its discussion of financial assets backing insurance contracts. The Board considered various alternatives at length, observing that all had advantages and disadvantages. Some alternatives would have amended IAS 39 *Financial Instruments: Recognition and Measurement* to permit amortised cost measurements for some financial assets that an entity might sell them in response to changing market conditions. The Board noted that fair value was a more relevant measurement in such cases. Furthermore, user response to ED 5 had strongly opposed extending the use of amortised cost in IAS 39 and extending its use would have created an inconsistency with US GAAP.

The Board noted that introducing a current market-based discount rate for insurance liabilities rather than a historical discount rate would improve the relevance and reliability of an insurer's financial statements. However, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires consistent accounting policies for similar transactions. For systems and other reasons, insurers may not wish in phase I to introduce a current market-based discount rate for all insurance liabilities.

The Board decided the following:

- No changes should be made to the measurement requirements in IAS 39 for financial assets.
- An insurer should be permitted, but not required, to change its accounting policies so that it remeasures some insurance liabilities in each period for changes in interest rates. This election permits a change in accounting policies that is applied to some liabilities, but not to all similar liabilities as IAS 8 would otherwise require. The Board noted that insurers might sometimes be able to develop simplified models that give a reasonable estimate of the effect of interest rate changes.

Property backing insurance contracts

Investment property

The Board decided to amend IAS 40 *Investment Property* to permit two separate elections when an entity selects the fair

value model or the cost model for investment property. One election would be for investment property backing contracts (which could be either insurance contracts or financial instruments) that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property. The other election would be for all other investment property.

If an entity makes different elections for the two categories, sales of investment property between different pools of assets should be recognised at fair value and the cumulative change in fair value should be recognised in profit or loss. In addition:

- If investment property is sold from a pool using the cost model into a pool using the fair value model, the cumulative change in fair value recognised in profit or loss should be disclosed separately.
- If investment property is sold from a pool using the fair value model into a pool using the cost model, disclosure would not be required of the cumulative change in fair value recognised in profit or loss. The fair value at the date of transfer would become deemed cost.

Some insurers operate internal real estate funds that issue notional units, with some units held by investors in linked contracts and others held by the insurer itself to back its other liabilities. The amendment to IAS 40 does not permit an insurer to measure the property held by such a fund partly at cost and partly at fair value.

Owner-occupied property

The Board decided not to amend the optional revaluation model in IAS 16 *Property, Plant and Equipment* to permit an entity to recognise changes in the fair value of owner-occupied property in profit or loss rather than in revaluation surplus.

Shadow accounting (see IASB *Update* December 2003) may be relevant if there is a contractual link between payments to policyholders and the carrying amount of, or returns from, owner-occupied property. If an insurer elects to use shadow accounting, changes in the measurement of the liability resulting from revaluations of the property would be recognised directly in equity, through the statement of changes in equity.

Investment contracts

The Board discussed the treatment of origination costs ('acquisition costs') incurred by the issuer of an investment contract (ie a contract that is a financial instrument rather than an insurance contract). The Board decided to clarify the following by adding guidance to the appendix of IAS 18 *Revenue*:

- Incremental costs directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract.
- The asset represents the entity's contractual right to benefit from providing investment services, and is amortised as the entity provides the services and recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a group basis.
- Some financial services contracts involve both the transfer of one or more financial instruments and the provision of investment management services. The provider of the contract distinguishes the transaction costs relating to the acquisition or issuance of the financial instrument from the

costs of securing the right to provide investment management services.

- When a financial liability is measured at amortised cost, the related origination fees received are included, with the transaction costs incurred, in its initial carrying amount and recognised as an adjustment to the effective yield.

To the extent that origination costs relate to a financial liability rather than to the provision of services, IAS 39 applies. The Board decided not to change the definition of transaction costs (see IAS 39 revised in December 2003).

Discretionary participation features

The Board discussed discretionary participation features in both insurance contracts and financial instruments. The Board decided not to change the definition of discretionary participation features proposed in ED 5.

The Board noted that the definition does not capture contracts in which the issuer has unconstrained contractual discretion to set a 'crediting rate' that is used to credit interest or other returns to policyholders (eg so-called 'universal life' contracts). Some view these as having characteristics quite similar to contracts with discretionary participation features, because crediting rates are constrained by market forces and the insurer's resources. The Board will revisit the treatment of these contracts in phase II.

The Board decided to clarify the following:

- The fixed (or guaranteed) element described in ED 5 is the portion to which individual policyholders have an unconditional right.
- The issuer of an insurance contract or investment contract containing a discretionary participation feature may classify the entire contract as a liability. If so, the liability adequacy test applies to that contract (see below).
- Alternatively, the issuer of an investment contract containing a discretionary participation feature may classify part or all of that feature as a separate component of equity. If so, the liability recognised must be no less than the measurement that IAS 39 would apply to the fixed (or guaranteed) element. However, the issuer need not determine the IAS 39 measurement if the liability recognised is clearly higher than the minimum required.
- IAS 1 *Presentation of Financial Statements* requires an entity to disclose the judgements, apart from those involving estimations, made in applying the accounting policies that have the most significant effect on the amounts recognised in the financial statements. The Implementation Guidance for the IFRS on insurance contracts should identify the classification of discretionary participation features as an example of an accounting policy that might have a significant effect.
- IAS 1 also requires an entity to disclose a description of the nature and purpose of each reserve within equity. This requirement is likely to be relevant for discretionary participation features classified in equity.
- Although investment contracts with discretionary participation features are presented as financial liabilities, the issuer may continue to present premiums as revenue, with a corresponding expense representing the change in the liability.
- If part or all of a discretionary participation feature is classified as a component of equity, the issuer may recognise the entire amount of the premiums received as revenue without separating the portion that relates to the equity component. The portion of profit or loss that relates

to the equity component is reported as an allocation of profit or loss, not as expense or income.

- Investment contracts containing a discretionary participation feature are within the scope of IAS 32 *Financial Instruments: Disclosure and Presentation*. The Board decided that these contracts should not be exempt from the required disclosure of fair value. If an entity cannot measure the fair value of that feature reliably, IAS 32 requires the entity to disclose that fact together with a description of the contract, its carrying amount, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is highly likely to lie.

Scope – financial guarantees and credit insurance

The Board reaffirmed the following proposals in ED 5:

- Financial guarantees can have various legal forms, such as that of a financial guarantee, letter of credit, credit default contract or insurance contract. The accounting should not depend on their legal form.
- A financial guarantee contract is within the scope of IAS 39 if it is not an insurance contract. A financial guarantee meets the definition of an insurance contract if it requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument, provided that the resulting risk transfer is significant.
- If a financial guarantee contract meets the definition of an insurance contract but was incurred or retained on transferring financial assets or financial liabilities to another party, it is within the scope of IAS 39. In general, IAS 39 prevents the derecognition of the transferred asset or liability.
- If a financial guarantee contract meets the definition of an insurance contract and was not incurred or retained on transferring financial assets or financial liabilities to another party, the contract is within the scope of the proposed IFRS on insurance contracts. However, as decided by the Board in finalising the recent amendments to IAS 39, the issuer should initially recognise it at fair value, and subsequently measure it at the higher of (i) the amount recognised under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and (ii) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*. The issuer is subject to the derecognition provisions of IAS 39.
- Unless there is evidence to the contrary, the fair value of a financial guarantee at initial recognition is likely to be equal to a guarantee fee received at market rates.
- Phase I does not give specific guidance on accounting for financial guarantees received. For contracts classified as insurance contracts, the beneficiary of the guarantee is a policyholder; policyholder accounting is beyond the scope of ED 5. For contracts within the scope of IAS 39, the beneficiary applies IAS 39; the application of IAS 39 to these contracts is beyond the scope of this project.

IAS 39 already applies to a financial guarantee given in connection with the transfer of financial assets or financial liabilities. ED 5 proposed that the transferor of a non-financial asset or liability should apply IAS 39 to a financial guarantee that it gives to the transferee in connection with the transfer. The Board decided to delete this proposal. As a result:

- If the guarantee is an insurance contract, the IFRS on insurance contracts applies. Otherwise, IAS 39 applies.

- If the issuer gave a financial guarantee in connection with the sale of goods, the issuer applies IAS 18 in determining when it recognises the resulting revenue.

Embedded derivatives

The Board followed up two topics discussed at the December Board meeting, relating to (i) the liability adequacy test (previously called loss recognition test) and (ii) interdependence.

Cash flows considered in a liability adequacy test

If an insurer does not apply a liability adequacy test that meets the minimum requirements specified in paragraph 11 of ED 5, the proposed IFRS requires it to use IAS 37 as the basis for a liability adequacy test. ED 5 proposed that phase I should impose no restrictions on an existing liability adequacy test beyond the two basic requirements to consider future cash flows and to recognise immediately any loss that the test identifies.

The Board decided to clarify that the cash flows to be considered include all contractual cash flows, including related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees. However, the Board decided that it would be premature:

- to specify whether the liability adequacy test should consider both the time value and the intrinsic value of embedded options and guarantees.
- to address the phase II topic of determining when existing contracts end and future contracts start.

Interdependence

An embedded derivative and a host insurance contract may be so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract). The Board decided that the embedded derivative is closely related to the host insurance contract

Changes in accounting policies

ED 5 stated that an accounting policy change makes financial statements less relevant and reliable if it introduces a practice of including future investment margins. Two practices that include future investment margins are:

- using a discount rate that reflects the estimated return on the insurer's assets.
- projecting the returns on those assets at an estimated rate of return, discounting those projected returns at a different rate and including the result in the measurement of the liability.

In December, the Board replaced the prohibition on the introduction of such a practice with a rebuttable presumption. In some measurement approaches, the discount rate is used to determine the present value of a future profit margin, which is then attributed to different periods using a formula. However, in other approaches (such as most applications of embedded value), the discount rate determines the measurement of the liability directly. At this meeting, the Board concluded that it is highly unlikely that an insurer could overcome the rebuttable presumption in the latter case.

Disclosure

The Board reviewed the staff's recommendations for amendments to the Implementation Guidance on disclosure (see observer notes available on the IASB's Website www.iasb.org. These notes were prepared before the decisions taken at this meeting, and are subject to further change.)

The disclosure material reflects current requirements in other IFRSs, particularly IAS 32. The Board noted that its project on Financial Risk and Other Amendments to Financial Instruments Disclosures may lead to amendments to IAS 32 and that these amendments could require consequential amendments to the disclosures for insurance contracts.

IAS 32 requires disclosure of a sensitivity analysis only for assumptions that are not supported by observable market prices or rates. However, phase I of this project does not require a specific method of accounting for embedded options and guarantees, including some that are partly dependent on observable market prices or rates. Therefore, the Board retained the proposal in ED 5 that an insurer should disclose a sensitivity analysis for all variables that have a material effect, including observable market prices or rates.

The Board decided to modify the disclosure requirements about claims development to focus on the period over which there is uncertainty about the amount and timing of the cash flows, rather than the period over which claims are settled.

The required disclosures include material changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs. The Board clarified that these disclosures should be presented as a reconciliation.

Other issues

The Board discussed various less significant issues related to investments in subsidiaries and associates, policyholder funds invested in the insurer's own financial instruments, elimination of transactions between policyholder interests and shareholder interests, presentation of linked investments and income taxes. The Board made no changes in these areas.

Transition and effective date

The Board reaffirmed the proposal in ED 5 that the IFRS should be mandatory for annual periods beginning on or after 1 January 2005. Early adoption would be encouraged. The Board also decided the following both for entities already applying IFRSs and first-time adopters:

- There should be an exemption from applying the IFRS to disclosures of comparative information that relates to annual periods beginning before 1 January 2005, except for information about the material amounts of recognised assets, liabilities, income and expense (and cash flows if the direct method is used).
- If it is impracticable to apply the recognition and measurement section of the IFRS to comparative information that relates to annual periods beginning before 1 January 2005, an entity should disclose that fact. In the Board's view, applying that section to comparative information might sometimes be impracticable for the liability adequacy test, but is highly unlikely to be impracticable otherwise. IAS 8 explains the meaning of the term 'impracticable'.
- As proposed in ED 5, an entity need not disclose information about claims development that occurred more than five years before the end of the first financial year in which it applies the IFRS. Furthermore, if it is impracticable, when an entity first applies the IFRS on insurance contracts, to disclose information about claims development that occurred before the beginning of the earliest period for which full comparative information is presented under IFRSs, the entity should disclose that fact.
- As proposed in ED 5, when an insurer changes its accounting policies for insurance liabilities, it should be

permitted, but not required, to reclassify some or all financial assets as 'at fair value through profit or loss'. The Board decided not to extend this to permit reclassification as available for sale.

Next steps

The Board has concluded its redeliberations of ED 5. It decided that the changes made to ED 5 do not require re-exposure and approved a Standard, subject to written ballot. The Board plans to issue an IFRS by the end of March 2004.

Five Board members indicated that they intend to dissent from the IFRS because of the suspension of the IAS 8 hierarchy. One of those Board members may also dissent because of concerns that the definition of an insurance contract is too imprecise and may permit entities to circumvent IAS 39. A sixth Board member may dissent because of concerns about shadow accounting.

Leases

The Board considered alternative approaches to recognising assets and liabilities arising from leases, particularly leases with options under the control of the lessee. The purpose of the discussion was to give further direction to the Leasing research project, being undertaken by staff of the UK Accounting Standards Board. No decisions were made.

Two alternative approaches were considered.

- Under the first approach, assets and liabilities would be recognised only in respect of unconditional rights and obligations under the lease. (This would mean, for example, that on initial recognition of the lease, a lessee would recognise the right to renew the lease, rather than recognise a lease obligation and a right to use in respect of a renewal period.)
- Under the second approach, the probability of the lessee exercising its options would be considered in recognising assets and liabilities under the lease. (This would mean, for example, that if on initial recognition it was considered probable that the lessee would renew the lease, a right to use and associated lease obligation would be recognised for the renewal period.)

Post-employment benefits

The Board considered the disclosures required by SFAS 132 *Employers' Disclosures about Pensions and Other Postretirement Benefits* (revised December 2003). It decided to propose the following additional disclosures in its exposure draft of amendments to IAS 19 *Employee Benefits*:

- reconciliations showing the changes in plan assets and plan liabilities, rather than the current reconciliation required by IAS 19 showing the changes in the recognised net liability or asset.
- disclosure of the major classes of assets held by the plan as a percentage of the total fair value of the plan assets.
- a narrative description of the basis used to determine the overall expected rate of return on assets as well as the disclosure of the expected rate of return for each major class of assets as previously decided by the Board.
- the employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the next fiscal year.

- an addition to paragraph 121 of IAS 19 to ensure that the description of the plan reflects any constructive obligation, for example commitments arising from past practice or a history of regular benefit increases.

The Board also decided to express the requirement for sensitivity information on the key assumptions (decided in May 2003) in terms that would give appropriate information for economies with high inflation.

The Board decided to include in the exposure draft a question whether the final amendments should also include the disclosure requirements in SFAS 132 that it decided not to propose, being:

- a narrative description of investment policies and strategies.
- encouraged disclosure of additional asset categories if that information is expected to be useful in understanding the risks associated with each asset category.
- the benefits expected to be paid in each of the next five fiscal years and in aggregate for the five fiscal years thereafter.
- an explanation of any significant changes in the plan liabilities or plan assets not otherwise apparent from the other disclosures.

The Board discussed whether, under the proposed option to recognise actuarial gains and losses immediately outside profit or loss, the actuarial gains and losses should be reported in a separate component of equity or in retained earnings. The Board asked the staff to analyse the issue and to present a paper at the February 2004 Board meeting.

Next steps

The Board was asked whether any Board members expected to express an alternative view in the exposure draft. Three members noted their intention to do so, citing the proposed exemption from defined benefit accounting in the separate financial statements of entities in a consolidated group that participate in a group defined benefit plan. The Board requested the staff to develop an alternative amendment to IAS 19 to be discussed at the February 2004 Board meeting that would bring such entities within the scope of the provisions in IAS 19 for multi-employer plans.

One of the Board members expressing an alternative view on the above issue also noted other reasons, as did two other Board members.

Revenue recognition

In previous meetings, the Board tentatively decided the main features of a conceptual model for contractual rights and obligations. The Board also tentatively decided that assets and liabilities arise from contracts only if they are enforceable. At its January meeting, the Board considered various issues concerning the meaning, and various aspects, of enforceable contracts.

The Board tentatively decided that:

- For the purpose of identifying unconditional contractual rights and obligations, a ‘contract’ should be defined as a set of promises that a court will enforce. This includes so-called ‘non-contractual promises’ that a court will enforce, such as promises enforceable under the doctrine of promissory estoppel in the United States. The definition should not specify the elements of a contract as these may vary by legal jurisdiction.
- The IASB *Framework* should state that unconditional rights and obligations could arise from both express and implied contracts. Factors giving rise to implied contractual rights and obligations should not be specified in the IASB

Framework or the revised IAS 18 *Revenue* as these may vary by legal jurisdiction. However, examples of factors to consider should be included in Implementation Guidance for the Standard.

- The IASB *Framework* should state that unconditional rights and obligations that meet the definition of an asset or a liability, respectively, could arise from either two-sided or one-sided contracts.
- An unconditional contractual right need not be worthy of enforcement (ie the benefits of enforcement exceed the costs) to meet the definition of an asset.
- The assessment of the probability that unconditional contractual rights will result in future inflows of economic benefits and unconditional contractual obligations will result in future sacrifices of economic benefits should affect the measurement of the related assets and liabilities, but not whether they are recognised.
- Cancellation and “cancellation-like” provisions granted to customers do not make contracts unenforceable, but do affect the nature and measurement of the unconditional rights and obligations that arise from the contracts.
- The nature of evidence that a contract exists should not be specified in the IASB *Framework* or the revised IAS 18 *Revenue*. For example, rebuttable presumptions based on customary business practices for documenting sales transactions should not be specified. However, examples of possible evidence to consider should be included in Implementation Guidance for the Standard.
- The rights and obligations arising from ‘side agreements’ (amendments to contracts such as cancellation or termination rights, and additional free or discounted deliverables) should be analysed in the same way as any other contract. The project initiated by IFRIC on linked transactions will consider whether the existence of side agreements should nullify or otherwise vary the recognition and measurement of assets and liabilities arising from the related contracts.

The Board also noted that revenues could arise in the absence of contracts, eg from accretion, discovery and rights that are not legally enforceable.

Meeting dates: 2004

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

18—20; 23, 24 February[†]

17—19 March

21—23; 26, 27 April[†]

19—21 May

21—25 June, Oslo, Norway[†]

20—22 July

22—24; 27, 28 September[†]

18—20 October, Norwalk, Connecticut, USA

15—19 November[†]

15—17 December

[†] Includes a meeting with the Standards Advisory Council

[‡] Includes meetings with partner standard-setters