BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

January 2005

The International Accounting Standards Board met in London on 19, 20 and 21 January, when it discussed:

- IAS 39 – Cash Flow Hedge Accounting of Forecast Intragroup Transactions
- IAS 39 and IFRS 4 – Financial Guarantee Contracts and Credit Insurance
- IAS 39 – Fair Value Option
- ED 7 *Financial Instruments: Disclosures*
- Insurance Contracts (Phase II)
- Small and Medium-sized Entities
- Income Taxes
- Segment reporting
- Conceptual Framework

IAS 39 – Cash Flow Hedge Accounting of Forecast Intragroup Transactions

In July 2004, the Board published an Exposure Draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement* - Cash Flow Hedge Accounting of Forecast Intragroup Transactions. The Exposure Draft proposed to clarify that IAS 39 (as revised in 2003) requires the designated hedged item in a foreign currency cash flow hedge to be a highly probable *external* transaction for the purposes of the consolidated financial statements.

At this meeting, a public education session was presented by Mark Kirkland, Vice President of Corporate Treasury at Philips. The presentation, which is available at http://www.iasb.org/meetings/0501.asp, included an explanation of how Philips and other multinational entities manage foreign currency risk and the practical implications of the proposals in the Exposure Draft. No decisions were made.

The Board expects to discuss the comment letters received on the Exposure Draft and issues arising from them at its meeting on 17-21 February.

IAS 39 and IFRS 4 – Financial Guarantee Contracts and Credit Insurance

In July 2004, the Board published an Exposure Draft on Financial Guarantee Contracts and Credit Insurance. The Exposure Draft defined a 'financial guarantee contract' as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs if a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

The Exposure Draft proposed that the issuer of such a contract should measure it initially at fair value. Subsequently, the issuer would measure it at the higher of:

- the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.
- an amount determined under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

At this meeting, the Board discussed the comment letters received. As a result of issues identified in the comment letters and staff analyses, the Board tentatively decided to permit two approaches:

- the approach proposed in the Exposure Draft, or
- applying IFRS 4 *Insurance Contracts*, but with a more rigorous liability adequacy test. In particular, in addition to meeting the minimum requirements specified in paragraph 16 of IFRS 4, the net liability recognised should not be less than the amount determined under IAS 37. This additional requirement would not apply to other types of insurance contracts.

The staff will develop more specific proposals for the Board to consider in February.

IAS 39 – Fair Value Option

The Board published in April an Exposure Draft of proposed amendments to IAS 39's fair value option in April. In September, it discussed the 116 comment letters received, when it noted that a large majority of respondents did not agree with the proposals in the Exposure Draft, including a majority of respondents in all categories except regulators. It also noted that reverting to the unrestricted fair value option in IAS 39 (as revised in March 2004) would not address the concerns of regulators, which were the reasons for publishing the Exposure Draft. Therefore, the Board asked the staff to explore whether there was an alternative solution that could be acceptable to all parties – the Board, regulators and other constituents.

In December, the Board considered a preliminary first draft of a possible new approach. This preliminary first draft is available on the IASB Website. It was also sent to various interested parties, with a request to notify the staff of any major issues by 1 January. At this meeting, the Board discussed the comments received in response to this request. (The Board noted that as these responses were received as part of an information consultation process they would not be made available on its website.)

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IAS 39 – Fair Value Option *(...continued)*

The Board noted the following points:

- all of the insurers and insurance representative bodies that responded were concerned that insurers would be unable to use the fair value option in cases when they considered it appropriate.
- as regards the first proposed situation in which the fair value option could be used (ie when its use 'eliminates a mismatch that would otherwise arise from measuring items on different bases'), many had read those words to require an *economic* match between two or more items for which the fair value option is proposed to be used, rather than a *measurement inconsistency* that is being removed. Also, some commented that the term 'eliminates' is too strong. For example, in the case of insurance liabilities whose measurement incorporates current information (see IFRS 4, paragraph 24) and related financial assets that would be classified as available for sale or measured at amortised cost, the measurement inconsistency would be reduced, but not eliminated.
- as regards the second proposed situation in which the fair value option could be used (ie when 'the nature of the entity's activities is such that designating a group of financial assets and/or financial liabilities as at fair value through profit or loss results in more useful information for users'), some were concerned that this condition might be interpreted too broadly, and was not sufficiently well specified to be applied consistently in practice. In contrast, others requested a broad interpretation, for example to allow the fair value option to be used for most or all of an insurer's financial instruments.
- as regards the third proposed situation in which the fair value option could be used (ie when '*designation* at fair value through profit or loss is simpler than applying the measurement that would otherwise be required by this Standard'), some respondents were concerned that this condition might be interpreted too broadly. Some of these respondents suggested limiting this condition to instruments containing embedded derivatives.
- many respondents commented on the proposed statement about the powers of prudential supervisors. All expressed concern. The two most common comments were that such a statement should not be included in an accounting Standard, and that it might be misread as allowing prudential supervisors to override the requirements in the Standard.

No decisions were made. The Board will continue to discuss the proposed new approach at its next meeting, with a view to holding one or more public meetings during the week of the March Board meeting (14-18 March), to which it intends to invite constituents with differing views. The Board's aim continues to be to establish whether the proposed new approach or a variant of it would be acceptable to all parties – the Board, regulators and other constituents.

ED 7 *Financial Instruments: Disclosures*

The Board continued its deliberations on issues raised by the comment letters responding to ED 7 *Financial Instruments: Disclosures*.

Capital disclosures

The Board decided:

- to confirm the proposal in ED 7 to require disclosure of a description of what the entity manages as capital, and to clarify in implementation guidance or the basis for conclusions that capital is not necessarily the same as equity.
- to confirm the proposal in ED 7 to require disclosure of qualitative information about the entity's objectives, policies and processes for managing capital.
- not to proceed with the proposal in ED 7 to require disclosure of whether the entity has complied with the capital targets set by management and of the consequences of any non-compliance with those targets.
- to confirm the proposal in ED 7 not to require disclosure of quantitative information about any externally imposed capital requirements.
- to confirm the proposal in ED 7 to disclose compliance with externally imposed capital requirements and consequences of non-compliance.

The Board noted that some of these issues might warrant further deliberation in the context of its project on small and medium-sized entities. In addition, the Board decided that the disclosure requirements about capital should be in the form of an amendment to IAS 1 *Presentation of Financial Statements*, rather than in the new IFRS.

Collateral disclosures

The Board decided:

- not to require the disclosure of the fair value of collateral pledged as security and other credit enhancements that was proposed in paragraph 39(b) of ED 7.
- to clarify that 'other credit enhancements' include netting agreements.

Information about the allowance account

The Board decided to retain the requirement to disclose a reconciliation of changes in the allowance account, subject to clarification that any account used to recognise a collective impairment of financial assets would be an allowance account.

Insurance Contracts (Phase II)

Project Plan

The Board reviewed a project plan for phase II of its project on insurance contracts. The project plan is in the observer notes for this meeting at http://www.iasb.org/uploaded_files/documents/8_960_0105ob3.doc. Among other things, the project plan notes the following points:

- In restarting the project, the Board is taking a fresh look at financial reporting by insurers. Past work by the Board and by its predecessor is a useful resource, but the Board does not feel bound by it. The only restrictions on a fresh look are the IASB's *Framework* and the general principles established in the IASB's existing Standards. Similarly, the Board can learn from national or industry practice, but will not be constrained by it.

- There are important interactions with other projects, particularly those on the conceptual framework, revenue recognition, accounting measurement, performance reporting, financial instruments and revisions to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and the project on liabilities and equity. Board members noted that the work on insurance contracts would proceed in parallel with these other projects and should not wait for their outcome. Furthermore, work on insurance contracts may generate useful inputs for those other projects.
- The Insurance Working Group formed to advise the Board and its staff has now met three times (September and November 2004 and January 2005) and is providing useful input.
- The initial output should be a discussion paper, incorporating the Board's preliminary views. The discussion paper should focus on key issues that determine the direction of the project, rather than a comprehensive discussion of all matters that might be included in a Standard.
- The project plan includes a list of eleven topic areas that need to be investigated during the project, and suggests that the discussion paper should aim to answer questions at approximately that level of detail. The topic areas are presented as described in previous discussions dating back to January 2003. The staff observed that the description of the topic areas needs some revision and Board members encouraged the staff to begin that revision.
- The Financial Accounting Standard Board's (FASB) agenda does not currently include a project on insurance contracts, but the FASB has expressed an interest in participating in a 'modified joint project'. In other words, the discussion paper would be developed primarily through the deliberations of the IASB, with input from the Insurance Working Group. Following analysis of comments received, the boards would undertake a joint project with the objective of issuing identical or substantially similar Standards.
- The discussion paper cannot be expected before the end of 2005, and quite possibly later. Developing an exposure draft would take at least 18 months from when the Board publishes the discussion paper and a standard would take at least another 12 months. Although some parties may be disappointed that progress cannot be faster, Board members noted that developing a high quality, converged solution will take time.

Educational session on non-life claims liabilities

The Board also held an educational session on methods for estimating non-life claims liabilities, led by representatives of the International Actuarial Association. No decisions were made.

Next Steps

The Board expects:

- to hold a further educational session on non-life insurance liabilities in February, focusing on discounting and on risk and uncertainty. No decisions are expected.
- to discuss non-life insurance contracts in March.

The Insurance Working Group meets next on 13 and 14 April in London.

Accounting Standards for Small and Medium-sized Entities

The Board reviewed and affirmed the summary of tentative decisions that the Board had made in December 2004 on the appropriate way forward for the project. A draft of the summary was included in the December 2004 issue of *Update*. The Board agreed to clarify, in the summary, that the IASB *Framework* should apply to all entities. However, the Board should consider recognition and measurement simplifications for SMEs, as well as disclosure and presentation simplifications, based only on user needs and cost-benefit considerations as provided for in the IASB *Framework*. There should be no other preconceived positions about such changes.

The staff has developed a project plan that includes:

- expanding the Advisory Group by adding preparers and users of SME financial statements; organising round-table meetings with preparers and users of SME financial statements;
- soliciting the views of the Standards Advisory Council;
- holding a meeting of the Advisory Group in the first or second quarter of 2005;
- leveraging several upcoming conferences at which SME accounting issues will be addressed.

A meeting of the Board's internal SMEs subcommittee has been scheduled to discuss the plan and provide guidance to the staff.

Short-term convergence - Income taxes

The Board considered the following issues on the recognition and measurement of income taxes:

- the use of enacted or substantively enacted tax rates
- the use of undistributed or distributed rates
- the interaction of the use of undistributed or distributed rates with the requirements for tax relating to the unremitted earnings of subsidiaries.

The Board had previously considered these issues and reached tentative decisions. The FASB considered the issues at its meeting on 19 January and the Board redeliberated them in the light of the FASB's tentative decisions.

The use of enacted or substantively enacted tax rates

When the Board previously discussed this issue, it tentatively decided to retain the use of enacted or substantively enacted rates in IAS 12 to measure tax assets or liabilities arising from temporary differences. However, it also decided to amend IAS 12 to clarify that 'substantively enacted' means that any expected change in the tax rate is virtually certain. The IASB noted that in some jurisdictions (eg the US) enactment may not be virtually certain until the change is signed into law.

The Board was advised of the FASB's tentative decision to retain the use of the enacted criterion and to clarify that enactment occurs when every action that is required for a measure to become law has occurred, other than purely perfunctory measures.

The Board discussed whether 'substantially enacted' should be based on probability of enactment or on the process of enactment. The Board decided that reaching a specified stage in the process should be required. It further decided that the specified stage should be that the process of enactment is complete, which is when the remaining steps will not change the outcome.

The Board asked the FASB staff to ask the FASB whether it would agree with such an approach.

The use of undistributed or distributed rates

When it previously discussed this issue, the Board tentatively decided that the tax rate applicable to undistributed profits is generally appropriate for measuring tax assets and liabilities arising from temporary differences. However, if there were an obligation to distribute a portion of those profits, any deferred taxes on that portion would be measured at the distributed rate.

The Board was advised that the FASB's had tentatively decided to use the distributed rate.

The Board reaffirmed its previous decision to use the undistributed rate.

The Board asked the staff to bring the issue back to the joint IASB/FASB meeting in April.

The interaction of the use of undistributed or distributed rates with the requirements for tax relating to the unremitted earnings of subsidiaries

The Board was advised that the FASB had concluded that the rates used (1) by a subsidiary in its individual financial statements, and (2) applied to that subsidiary in the consolidated financial statements should generally be consistent with one another. Therefore, the FASB had tentatively decided to grant an exception to its general rule to use the distributed rate. This exception would apply to those subsidiaries whose unremitted earnings are except from the requirement for the group to provide deferred tax because they are permanently reinvested.

The Board reaffirmed its previous conclusion that there was no inconsistency in providing deferred tax on unremitted earnings in the consolidated financial statements, and using the undistributed rate to measure temporary differences for each of the individual entities in the group. The Board noted that additional temporary differences exist, and different tax rates apply, to the group as a whole from those in the individual entities. When recognising group income, it is necessary to recognise all taxes that will be incurred in making that income available for distribution outside the group. However, the consequences of distribution outside of the group should not be anticipated in advance of an obligation to make the distribution.

Other matters

The Board also decided:

- to add the wording of the requirements relating to graduated tax rates to the scope of the project.
- to consider in the joint purchase method procedures project the accounting for tax attributes of an acquirer that become realisable as a result of the acquisition.
- to consider whether to include in IAS 12 guidance on the following areas that are covered in SFAS 109:
  - income statement recognition requirements following a business combination
  - computation process for determining deferred taxes
  - special deductions
  - alternative minimum taxation requirements
  - sources and types of information that should be considered in measuring the realisability of deferred tax benefits
  - taking tax planning strategies into account in determining the realisability of deferred tax benefits
  - assessing and weighing the negative and positive evidence that supports the measurement of the realisability of deferred tax benefits
  - impact of a change in an entity's tax status on current and deferred taxes
  - regulated entities
  - measuring the realisability of deferred tax benefits associated with foreign investments
  - prorating of the valuation allowance between current and non-current deferred tax assets
  - allocating the consolidated amount of current and deferred tax expense for a group that files a consolidated tax return among the members of the group when those members issue separate financial statements.

Lastly, the Board stated it intention to publish an exposure draft proposing amendments to IAS 12 concurrently with the FASB publishing an exposure draft proposing amendments to SFAS 109. The same words would be used in those amendments wherever possible. The Board did not intend to fundamentally restructure or rewrite the whole of IAS 12 in this project.

Short-term convergence - Segment reporting

The staff presented a paper setting out the differences between IAS 14 *Segment Reporting* and SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*, academic research findings on segment reporting after implementation of SFAS 131, a summary of a meeting with analysts and staff recommendations. The Board discussed the approaches of the two standards on segment reporting. The Board decided to adopt the management approach of SFAS 131 and to converge with SFAS 131.

The Board asked the staff to consider extending the scope of IAS 14, given the approach taken by other standard setters. The Board also asked the staff to consider the subsequent work of the FASB and Canadian Accounting Standard Board (AcSB) on their respective standards on segment reporting (SFAS 131 and the Canadian standard were the result of a joint project between the FASB and the AcSB).

Conceptual Framework

When the IASB and FASB decided, at their joint meeting in October 2004, to undertake a joint project that has as its objective the development of a common conceptual framework—a single framework in which the existing frameworks of the two Boards converge and which improves upon them—the Boards also agreed with a staff proposal to publish an initial communications document.

At its January 2005 meeting, the Board discussed the staff's draft of that initial communications document. It is meant to inform constituents about the joint project, address the need for a conceptual framework, and explain how the existing IASB and FASB frameworks meet part, but not all of, that need. Board members discussed whether the draft document suited the expected audience, emphasized the appropriate topics, and incorporated sufficient background information from existing frameworks. The Board approved the issuance of this document, after revisions are made in response to comments from IASB and FASB members.

The staff noted that it expects to bring a formal work plan for the Conceptual Framework project to the Board next month.

Meeting dates: 2005

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

2005

10 and 11†; 14—18 February

14—18 March

18—22 April (joint with FASB)

16—20 May

20—24; 27 and 28† June

18—22 July

19—23 September

17—21 October (joint with FASB), Norwalk, Connecticut, USA

10 and 11†; 14—18 November

12—16 December

† Includes a meeting with the Standards Advisory Council