BOARD DECISIONS ON INTERNATIONAL FINANCIAL REPORTING STANDARDS

IASB UPDATE

May 2006

IASB Update is published as a convenience for the Board's constituents. All conclusions reported are tentative and may be changed or modified at future Board meetings.

Decisions become final only after completion of a formal ballot to issue a Statement, Interpretation or Exposure Draft.

The International Accounting Standards Board met in London on 23 – 26 May, when it discussed:

- Business Combinations II
- Insurance
- Accounting standards for small and medium-sized entities
- Fair value measurement
- Service concession arrangements
- IAS 37 redeliberations
- Employee benefits (pensions)
- IFRIC Update
- IAS 24 *Related Party Disclosures*
- IFRS 1

Business Combinations II

The Board continued its redeliberations of the implications of applying the recognition and measurement principles that are expected to be the foundation of the final business combinations standard. The Board discussed the accounting in a business combination for assets held for sale, assets or liabilities related to employee benefit plans, and assets and liabilities related to operating leases.

Assets held for sale

The Board discussed whether assets acquired in a business combination that meet the criteria in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* at the acquisition date should be measured at fair value less costs to sell, rather than fair value. This exception was proposed in the exposure draft. The Board tentatively decided to remove the proposed exception and amend IFRS 5 by replacing the words 'fair value less costs to sell' with 'fair value'.

The Board also asked the staff to make it clear in the final business combinations standard that it is the acquirer, and not the acquiree, that must meet the criteria in IFRS 5 at the acquisition date.

Employee benefit plans

The Board discussed whether the final business combinations standard should retain the proposed exception from fair value measurement for post-employment benefits acquired in a business combination. The Board tentatively decided to retain this exception. Therefore, those assets and liabilities would be measured in accordance with IAS 19 *Employee Benefits*. The Board observed that in applying IAS 19 in a business combination the acquirer would be required to measure any asset or liability related to the acquiree's employee benefit plans at the present value of the obligation less the fair value of any plan assets as set out in IAS 19 paragraph 108.

Operating leases

The staff asked the Board if guidance on the accounting for operating leases acquired in a business combination should be included in the final business combinations standard. The Board tentatively decided to include guidance, covering the following matters:

- The acquirer should recognise rights and obligations related to an operating lease in which the acquiree is the lessee as a net amount, rather than separately as an asset and a liability. The acquirer should recognise an intangible asset (liability) if the terms of the lease are favourable (unfavourable) relative to market terms at the acquisition date.
- An operating lease contract might have value for reasons other than terms that are favourable relative to market prices because of a related intangible asset. If an at-market lease has an associated intangible asset, the acquirer should account for that intangible asset in the same manner as other intangible assets acquired in a business combination.

The staff are further analysing the accounting for operating leases when the acquiree is the lessor and will bring their recommendations back to the Board at a future meeting.

Insurance

The Board discussed the following:

- Universal life contracts
- Unit-linked and index-linked payments
- Credit characteristics of insurance liabilities
- Reinsurance
- Relevant FASB projects
- Salvage and subrogation
- Business combinations and portfolio transfers

Universal life contracts

The Board had a preliminary discussion of universal life insurance contracts that allow the policyholder to vary premiums, subject to specified minimums and maximums and allow the insurer to vary charges to policyholders within specified limits. The staff will develop more detailed material, including examples, for a future meeting.

Unit-linked and index-linked payments

The Board discussed obligations to pay policyholders on the basis of an internal or external investment fund (unit-linked payments) or an index (index-linked payments). The Board noted that profit or loss could be affected when a unit-linked fund holds investments that are not measured at fair value through profit or loss. The Board observed that it would be preferable to eliminate such effects, but noted that eliminating them might create inconsistencies with other requirements of IFRSs. For example, the Board noted that some unit-linked funds hold shares of the issuing insurer and under existing IFRSs those shares are treated as treasury shares rather than as assets and are deducted from equity.

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Insurance (continued)

The Board considered several alternatives to address this concern including an adjustment to the measurement of the related unit-linked insurance liability, and recognition of those shares as an asset. The Board did not express a clear view on these alternatives. Therefore the staff will investigate whether there are viable approaches that could address this concern.

Credit characteristics of insurance liabilities

The Board expressed its view that the current exit value of a liability is the price for a transfer that neither improves nor impairs the credit characteristics of the liability. Therefore:

- the initial measurement of an insurance liability should reflect its credit characteristics. If the credit characteristics affect the measurement materially, the insurer should disclose the effect.
- the subsequent measurement of an insurance liability should reflect changes in the effect of its credit characteristics (ie changes in the probability of default or changes in the price for possible default). An insurer should disclose changes in the effect of its credit characteristics. The staff will investigate how that effect should be quantified, given that a change in credit characteristics may be correlated with other factors, such as changes in interest rates.
- the current exit value of an insurance liability guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness.

Reinsurance

The Board discussed approaches to accounting for reinsurance contracts, and tentatively decided:

- The measurement attribute for reinsurance assumed (inwards reinsurance) should be current exit value.
- The measurement attribute for reinsurance assets (outwards reinsurance) should be current exit value.
- For risks associated with the underlying insurance contract, a risk adjustment typically increases the measurement of the reinsurance asset, and is equal in amount to the risk adjustment for the corresponding portion of the underlying insurance contract. The Board noted that the conclusion on risk adjustments for reinsurance assets may also be relevant when the Board considers policyholder accounting after the Discussion Paper stage of the project.
- The carrying amount of reinsurance assets should be reduced by the expected (probability-weighted) present value of losses from default or disputes, with a further reduction for the margin that market participants would require to compensate them for bearing the risk that defaults or disputes exceed expected value.
- Given the Board's preference for using current exit value as the measurement attribute for insurance contracts, there is no need to restrict the recognition of gains or losses when an insurer buys reinsurance.
- A cedant should recognise at current exit value its contractual right, if any, to obtain reinsurance for contracts that it has not yet issued. In practice, that current exit value may not be material if the cedant's contractual right relates to insurance contracts that will be priced at current exit value.

Relevant FASB projects

The staff briefed the Board on developments in relevant projects of the US Financial Accounting Standards Board (FASB). The Board agreed with the staff's conclusions that:

- The FASB's work on insurance risk transfer is unlikely to require changes to the IASB's tentative decision in April, that phase II should not require insurers to unbundle deposit and service components of insurance contracts for the purpose of recognition and measurement. After this meeting the IASB staff will consider whether unbundling should be prohibited in some or all cases. The Board will also discuss at a future meeting whether an insurer should recognise some or all premium receipts as deposit receipts rather than as revenue.
- The IASB should not consider the following issues until after the Discussion Paper stage, when the Board will have the benefit of input from constituents and of the FASB's work on risk transfer and on financial guarantee contracts:
  - whether unbundling (bifurcation) is appropriate if some or all premiums are presented as revenue.
  - the definition of an insurance contract.
  - whether the accounting model being developed for insurance contracts in general is also appropriate for financial guarantee contracts that meet the definition of an insurance contract.
  - policyholder accounting. The staff will consider whether it would be appropriate to develop a separate discussion paper on policyholder accounting.

Salvage and subrogation

The Board discussed issues related to salvage and subrogation and tentatively decided that:

- insurance liabilities should be measured net of the effect of related rights to salvage and subrogation that the insurer contractually is entitled to if it pays a claim.
- once an insurer pays a claim and acquires salvage or subrogation rights, the insurer has a separate asset. The insurer should measure that asset initially at current exit value.

The Board agreed that until it has discussed reimbursement rights in the project to amend IAS 37, it will not decide how an insurer should measure salvage and subrogation rights after initial measurement.

Business combinations and portfolio transfers

IFRS 4 permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer which would initially be recorded at fair value. The Board noted that, if any significant differences remain between current exit value and fair value when the Board completes phase II of this project, it may be necessary to consider retaining the expanded presentation. If no significant differences remain, the expanded presentation will become redundant.

When an entity takes over a portfolio of insurance contracts in a portfolio transfer, the current exit value of the portfolio at that date is likely to equal the consideration plus the fair value of any other assets received (eg investments or recognisable intangible assets relating to customer relationships). The Board tentatively decided that, if the current exit value is a different amount, the transferee should recognise the difference as income or expense.

Next steps

At a future meeting, the Board will discuss two items carried forward from the May agenda: policyholder participation rights and changes in insurance liabilities.

The IASB's Insurance Working Group will meet in London on 29 and 30 June 2006. The staff will seek feedback from Working Group participants on the Board's preferred direction so far. The staff plans to begin work on drafting a discussion paper after that meeting, with the aim of publishing it before the end of 2006. All Board meetings and Working Group meetings are open to members of the public who register in advance. The IASB's web site www.iasb.org contains information on registering for these meetings.

Accounting standards for small and medium-sized entities

The Board discussed a revised draft Exposure Draft *International Financial Reporting Standard for Small and Medium-sized Entities*. The draft reflected changes since the version discussed at the Board meetings in January-March 2006.

Stand-alone document

The Board expressed its view that the IFRS for SMEs is intended to be a stand-alone document. There will be occasions, however, when the IFRS for SMEs will require some entities to look to other IFRSs:

- When IFRSs provide an accounting policy choice, the Board has concluded that SMEs should have the same options. The simpler option is included in the IFRS for SMEs. Entities wishing to use the other option or options are permitted to do so by cross-reference to the relevant IFRSs.
- The draft IFRS for SMEs omits some accounting topics that are addressed in other IFRSs, because the Board believes that the typical SME is not likely to encounter such transactions. However, the IFRS for SMEs has explicit cross-references requiring an SME that encounters such transactions to look to all or part of the relevant IFRS.
- The draft IFRS for SMEs states that if the IFRS for SMEs does not address a transaction, event or condition or provide an explicit cross-reference to another IFRS, an SME should select an accounting policy that results in relevant and reliable information. In making that judgement, an SME should consider, first, whether the appropriate accounting can be determined by analogising from the principles in the IFRS for SMEs. If those principles do not provide guidance, the SME should consult the full text of other IFRSs. This requirement to consult IFRSs is in the nature of a 'safety net' that the Board expects to be invoked only in limited circumstances.

In adopting the IFRS for SMEs, a jurisdiction could elect to include all or part of an IFRS that is cross-referenced. This could be helpful if a topic was especially relevant to SMEs in that particular jurisdiction. For example, in hyperinflationary economies, the full text of IAS 29 *Financial Reporting in Hyperinflationary Economies* could be incorporated into the IFRS for SMEs for such jurisdictions.

Invitation to Comment

The Invitation to Comment on the exposure draft will ask about:

- ways to make the IFRS for SMEs more self-contained;
- whether other cross-references to IFRSs should be added or some of those included should be deleted; and
- whether accounting options should be deleted and, if so, which one(s) and why.

The Invitation to Comment will explain the Board's plan for updating the IFRS for SMEs and invite comments.

Basis for Conclusions

The Basis for Conclusions should indicate that in developing the IFRS for SMEs the Board had in mind an entity with about 50 employees and that each individual jurisdiction must decide which non-publicly accountable entities should be required or permitted to use the IFRS for SMEs, or perhaps even prohibited from using it.

The Basis for Conclusions should identify any changes made to the recognition and measurement principles in other IFRSs and the reasons for those changes, and also changes proposed by the IASB SME Working Group and others that were not made and the reasons for rejecting those proposals.

Staff review. Over the next several weeks, IASB project staff will review sections of the draft Exposure Draft to consider whether:

- rewording of principles from IFRS had inadvertently changed the requirements.
- any of the omitted requirements from IFRSs should be reinstated.
- there is further material that could be omitted.

Definition of an SME. The definition will be amended so that an entity that is a public utility or similar entity that provides an essential public service would not be considered publicly accountable by definition.

Pervasive measurement principles. The draft Exposure Draft included some pervasive principles for recognising assets, liabilities, income, and expenses, based on the IASB *Framework*, and also some newly developed pervasive measurement principles not in the *Framework*. The pervasive measurement principles will be deleted.

Fair presentation override. The Board concluded that paragraphs 13-22 of IAS 1 should be included in the IFRS for SMEs. These paragraphs provide guidance when the relevant regulatory framework requires or prohibits departures from IFRSs to achieve a fair presentation.

Business combinations. Material on business combinations should be removed from the IFRS for SMEs and, instead, will be addressed by cross-reference to IFRS 3 *Business Combinations*.

Glossary. The definitions in the glossary should be conformed to those in the 2006 Bound Volume of IFRSs, or the difference should be explained.

Current exposure drafts. Conclusions in current exposure drafts of other standards should not be reflected in the SME Exposure Draft but, if different from the SME Exposure Draft, should be noted in a footnote.

Combined statement of income and retained earnings. Previously, the Board had concluded that if the only changes to an SME's equity during a period arise from profit and loss and payment of dividends, the SME may present a combined statement of income and retained earnings instead of separate income and equity statements. The Board clarified that an SME is eligible to present a combined statement of income and retained earnings if its equity changes as a consequence of (a) correction of a prior period error or (b) changes in accounting policy, in addition to changes as a consequence of profit and loss and dividends.

Financial instruments. The section of the draft Exposure Draft covering financial instruments had not previously been discussed by the Board. The Board made numerous changes to this section, including:

- The IFRS for SMEs should require a financial asset to be measured at fair value through profit and loss when its fair value is readily obtainable or it is a derivative.
- Some guidance on fair value should be added to the draft ED, with a cross-reference to the more detailed guidance in IAS 39 *Financial Instruments: Recognition and Measurement*.
- Initial measurement of financial instruments is at fair value, consistent with IAS 39. Hedge accounting guidance should be included by cross-reference to IAS 39.
- The Board tentatively decided that the fair value option applicable to SMEs should be unrestricted. The Board noted that it has restricted the fair value option in IAS 39 in response to concerns of bank regulators, which are not applicable to SMEs.

Staff will revise this section with the counsel of two Board members.

Income taxes. The draft Exposure Draft included a requirement that deferred tax assets and liabilities should be recognised for all taxable differences between carrying amounts and tax bases of assets and liabilities (ie the various exceptions and special rules in IAS 12 *Income Taxes* would be eliminated). The Board tentatively decided to give SMEs the same exceptions as are in IAS 12. The Board also asked the staff to consider whether some of the Board's decisions, to date, in its project to revise IAS 12 should be incorporated into the draft IFRS for SMEs.

Development cost. The draft Exposure Draft will include an option for an SME to charge all development cost to expense. An SME that wishes to capitalise development cost would be directed to the requirements of IAS 38 *Intangible Assets.*

Combined financial statements. A description of these should be added. It should be made clear that if an entity chooses to present combined financial statements, it must comply in full with the IFRS for SMEs.

Fair value measurement

The Board continued its discussions of the FASB's draft Fair Value Measurements (FVM) statement. The FVM project was added to the Board's agenda in September 2005. The objective of the project is to define fair value more clearly and to provide guidance on measuring fair value when its use is required by another standard. The project is not intended to require additional fair value measurement or to increase the use of fair value in IFRSs.

The current project plan is to publish the FASB's final FVM statement as an IASB exposure draft. The invitation to comment will discuss those matters where the Board does not agree with the conclusions of the FASB or where the Board believes that additional guidance is needed. The FVM project is one part of the Memorandum of Understanding with the FASB and seeks to issue converged guidance on measuring fair value by 2008. The staff noted that in June they plan to review the current plan with the Board. The purpose of this review is to consider this project plan in relation to the IASB's Due Process Handbook.

The staff set out the principles that form the foundation of the IASB's fair value measurements project. These principles were developed from existing IFRS guidance on fair value measurements, the FASB's draft FVM statement and from minutes of IASB and FASB discussions on measuring fair value.

Principles of a fair value measurement

- The objective of a fair value measurement is to determine the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date.
- The definition of fair value and its measurement objective should be consistent for all fair value measurements required by IFRSs.
- A fair value measurement should reflect market views of the attributes of the asset or liability being measured and should not include views of the reporting entity that differ from market expectations.
- A fair value measurement should consider the utility of the asset or liability being measured. As such, the fair value measurement should consider the location and the condition of the asset or liability at its measurement date.

Following the discussion of the principles, the staff presented papers on many aspects of the FASB's draft FVM statement. In discussing the draft FVM statement, the Board expressed its view that:

- Fair value should be defined as 'the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date' (an exit price).
- The three-level hierarchy in the FASB's draft FVM statement appropriately prioritises observable market inputs over unobservable inputs. A common hierarchy should be applied to all fair value measurement required by IFRSs as opposed to the disparate guidance currently in IFRSs.
- Determining the appropriate unit of account is a key element in measuring fair value. However, the unit of account is different for different assets, liabilities and transactions. Therefore, the unit of account cannot be established within the fair value measurement standard. Rather, the appropriate unit of account will be determined on the basis of guidance in each standard requiring a fair value measurement.
- When multiple markets exist for an asset or liability, the fair value measure should be based on the principal market for that asset or liability. If there is no principal market, the most advantageous market should be used. In both instances, the principal or most advantageous market should be determined from the perspective of the reporting entity.
- A transaction price paid to acquire an asset or received to assume a liability in an entry price whereas fair value is tentatively defined as an exit price. Conceptually, these are different. While the transaction price will represent fair value in many circumstances on initial recognition, the

reporting entity cannot assume that the transaction price represents fair value without considering the nature and characteristics of the transaction.

- When inputs to a fair value measurement are based on bid and asked prices, the fair value measurement should be at the price within the bid-asked spread at which market participants would enter into a transaction at the transaction date. Additionally, the same price should be used for offsetting long and short positions in the same instrument. The FASB's draft FVM statement does not preclude the use of a consistently applied pricing convention (such as mid-market pricing). The Board expressed concerns about using consistently applied pricing convention.
- Transaction costs should be excluded from a fair value measurement because these costs are an element of the transaction to sell or transfer the asset or liability. However, the Board clarified that fair value measurement should consider the attributes of the asset or liability in its current location and condition. Therefore, if location is an attribute of an asset or liability (such as a commodity) the fair value measure should consider costs that would be incurred in getting the asset to the principal or most advantageous market. The Board agreed with the staff that this concept could be more clearly communicated in the FASB's draft FVM statement. Therefore this issue will be highlighted in a question in the invitation to comment.

The staff plans to resume discussions of the FASB's FVM statement in June. The Board indicated it would revisit the discussion of the statements to which this fair value measurement guidance should apply before publishing the exposure draft.

Service concession arrangements

The Board held a session to discuss service concession arrangements. The meeting was for education only and no decisions were made. The observer note is available at: www.iasb.org/meetings/may2006.asp.

IAS 37 redeliberations

The Board started redeliberating issues associated with the recognition principle proposed in the IAS 37 Exposure Draft (ED). This principle would require an entity to recognise a liability when (a) the definition of a liability has been satisfied, and (b) the liability can be measured reliably.

The meaning of the phrase 'expected to' in the definition of a liability

The definition of a liability in the *Framework* includes the phrase 'expected to result in an outflow from the entity of resources embodying economic benefits'. The Board noted that some respondents to the ED argued that this phrase implies that a particular degree of certainty about the outflow of resources associated with a present obligation is required before the obligation meets the definition of a liability. Hence, some argued that obligations with a remote or low likelihood of future settlement would not meet the definition of a liability.

In the light of these comments, the Board decided to clarify that 'expected to' is not intended to imply that there must be a particular degree of certainty that an outflow of benefits will occur before an item meets the *Framework's* definition of a liability. The Board also noted that its view was consistent with the use of the word 'probable' in the definition of a liability in the FASB's Concept Statements.

Determining whether an entity has a liability when the existence of a present obligation is uncertain

The Board noted that many respondents believed that the ED provided insufficient guidance on determining whether a liability exists (and hence should be recognised), particularly in cases in which the existence of a present obligation is uncertain. The Board agreed with those respondents and decided to include additional guidance in any final Standard.

The Board noted that paragraph 15 of the current IAS 37 specifies a 'more likely than not' threshold for determining whether a present obligation exists. However, the Board noted that the question it was trying to address was does a liability exist, rather than is it more likely than not that a liability exists? Accordingly, the Board directed the staff to determine whether it is possible to develop a list of indicators to assist an entity in determining whether a liability exists. The Board acknowledged that a list of indicators alone might not provide sufficient guidance to ensure consistent application.

Stand ready obligations

The ED proposed introducing into IFRSs the notion of a stand ready obligation. The Board noted that many respondents believed that the explanation of a stand ready obligation in the ED was too broad and would lead to the recognition of an almost limitless number of items (including items currently regarded as general business risks, not liabilities).

The Board began by confirming that a stand ready obligation must satisfy the *Framework*'s definition of a liability to be recognised. The Board then discussed some examples that the staff had developed to assist in distinguishing a liability from a general business risk.

The Board instructed the staff to work with the conceptual framework project team to develop further examples to clarify the ED's explanation of a stand ready obligation and to distinguish between a stand ready obligation and a general business risk.

Employee benefits (pensions)

The Board held a preliminary discussion on whether to add a project on employee benefits (pensions) to its active agenda. The Board instructed the staff to develop an agenda proposal for a comprehensive long-term project that would involve a fundamental rethink of all aspects of pension accounting. The Board also instructed the staff to identify issues within the project that could be resolved relatively quickly, with a view to issuing an interim standard that would significantly improve pension accounting within four years. The Board noted that the FASB was also undertaking a two-phase project and that, although the timing and scope of the first phases might differ, the objective of both boards was ultimately to arrive at a converged standard. The agenda proposal will be discussed with the SAC and Trustees before being considered by the Board for an agenda decision.

IFRIC Update

The Board received a report on the recent meeting of the IFRIC. Details of the meeting will be available in the May edition of IFRIC *Update*, which was about to be published. At the May meeting the IFRIC decided to recommend the Board to approve for publication an Interpretation on Interim Reporting and Impairment. The Board confirmed its previous preference that this issue should be dealt with through an Interpretation rather than by amendment of standards.

IAS 24 Related Party Disclosures

The Board held a preliminary discussion on whether to add to its active agenda a project on amendments to IAS 24 *Related Party Disclosures*. The staff's initial view was that the project would encompass a review of the disclosure requirements for entities with significant state ownership when they enter transactions with similar entities. The project would also consider whether when an associate of an entity prepares its own financial statements, transactions between the associate and a subsidiary of the associate's significant investor should be included as related party transactions.

The Board instructed the staff to develop an agenda proposal for amendments to IAS 24. The agenda proposal will be discussed with the SAC and Trustees before being brought to the Board for an agenda decision.

IFRS 1

At its meeting in March 2006, the Board added to its technical agenda a project to resolve issues relating to accounting for a subsidiary in the separate financial statements of a parent on first-time adoption of IFRSs.

At this meeting, the Board discussed potential amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* relating to relief from determining cost in accordance with IAS 27 *Consolidated and Separate Financial Statements* on transition to IFRSs.

The Board instructed the staff to analyse the possibility of amending the definition of cost in IAS 27. No decisions were made.

Meeting dates: 2006

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

19—23 June

17—21 July

18—22 September

16—20 October

23—24 October (joint with FASB), Norwalk, Connecticut, USA

13—17 November

11—15 December