BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

January 2002

The International Accounting Standards Board met with its partner standard setters in London, UK, on 21 and 22 January 2002, and in technical session on 22 – 25 January. It discussed:

- Business combinations
- Improvements to existing IASB Standards
- IAS 19, *Employee Benefits*
- Insurance contracts, and
- Reporting performance.

Meeting with National Chairs

On 21 and 22 January 2002, the IASB met the chairs of those national accounting standard-setters having an IASB liaison member in residence. All such standard-setters were represented. The meeting focused on:

- The IASB's and the national standard setters' technical agendas, and
- Making operational the 'partnership' between the IASB and national standard setters envisaged by the IASC Strategy Working Party and the IASB Constitution.

IAS 19 *Employee Benefits*

The Board decided to take action to deal with an unintended effect of the pensions standard, IAS 19 *Employee Benefits*.

Reflecting the recent fall in global equity markets, many pension plans have suffered actuarial losses. The IASB considered advice from the accounting profession that IAS 19 would have an unintended effect in those situations. The IASB agreed that reporting an asset (and a gain) as a consequence of actuarial loss is an unacceptable consequence of applying IAS 19 in some situations. It will prepare an Exposure Draft of a very small amendment to IAS 19 to ensure that no such gains would be recognised. The draft is expected to be published at the end of February 2002.

Business combinations – Phase I

Measurement date for equity instruments issued as consideration

At its December 2001 meeting, the Board considered, as part of its joint IASB/FASB business combinations project, the measurement date for equity instruments issued as consideration in a business combination. At that meeting, the Board tentatively agreed to adopt an agreement date model for measuring such equity instruments and to amend IAS 22 *Business Combinations* in this respect as part of phase I of this project. However, as a result of the FASB's decision earlier in January 2002 to change to a model consistent with that in IAS 22 (that is, a date of control model), the Board observed that achieving convergence on this issue might take longer than initially expected. Therefore the Board agreed to defer to Phase II of its business combinations project any changes to the requirements in IAS 22 for the measurement date for equity instruments issued as consideration in a business combination (other than to incorporate the requirements of SIC-28 *Business Combinations – "Date of Exchange" and Fair Value of Equity Instruments*).

Future tax cash flows and the calculation of value in use

The Board has previously agreed that goodwill impairments should be identified and measured by reference to the recoverable amount of a group of cash-generating units, with recoverable amount being the higher of net selling price and value in use. At this meeting, the Board tentatively agreed that:

- The calculation of value in use should include only those tax cash flows that would arise if the tax base of the asset equalled its value in use.
- IAS 36 *Impairment of Assets* should specify a particular calculation method. That method should require the projection of the tax cash flows that would arise if the tax base of the asset equalled its value in use and the use of a post-tax rate to discount the cash flows.
- When goodwill has a tax base of nil, there should be an exception to the requirement for value in use to include only those tax cash flows that would arise if the tax base of the asset equalled its value in use. Instead, the calculation of value in use should include the tax cash flows that will arise with the tax base of goodwill equalling nil. It was further agreed that this exception should apply whenever IAS 12 *Income Taxes* prohibits the recognition of a provision for the effect of the difference between the carrying value and the tax base.
- No action should, at this stage, be taken to counter the inconsistency that arises because value in use will include some discounted tax cash flows whilst IAS 12 prohibits the discounting of deferred tax balances.
- IAS 36 should clarify that impairments should be identified and measured by comparing value in use calculated in the above manner with the carrying value of the unit *excluding* any related deferred tax balance.

(continued…)

**30 Cannon Street,
London EC4M 6XH, United Kingdom
E-mail: iasb@iasb.org.uk
Internet: www.iasb.org.uk**

**IASB Publications Department,
7th Floor, 166 Fleet Street, London,
EC4A 2DY
United Kingdom
Tel: +44 (0)20 7427 5927
Fax: +44 (0)20 7353-0562
E-mail: publications@iasb.org.uk
ISSN 1474-2675**

The Board also agreed that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* should be amended to require expected pre-tax cash flows to be discounted at a post-tax rate for all provisions.

Reverse acquisitions

The Board tentatively agreed to include as an appendix to the revised standard guidance and an example addressing the following issues (based on EIC-10 *Reverse Takeover Accounting*, developed by the Emerging Issues Committee of the Canadian Accounting Standards Board):

- The way in which consolidated financial statements prepared following a reverse acquisition should be described and which financial statements should be presented as comparative information.
- The way in which the cost of acquisition should be determined and allocated in a reverse acquisition.
- The way in which the shareholders' equity section of the consolidated balance sheet should be determined and presented following a reverse acquisition.
- The way in which the interests of shareholders of the legal subsidiary that have not exchanged their shares for shares in the legal parent should be accounted for in the consolidated financial statements following a reverse acquisition.
- The calculation of earnings per share (for current and comparative figures) in the period in which a reverse acquisition occurs.

The Board also tentatively agreed that the guidance in paragraph 12 of IAS 22 for identifying when reverse acquisition accounting is appropriate should be amended to ensure that the identification of the acquirer in a business combination effected through an exchange of equity instruments is consistent with the way in which an acquirer is required to be identified for any other business combinations (that is, based on control).

Disclosures about recoverable amount

The Board tentatively agreed that IAS 36 *Impairment of Assets* should require disclosure of a range of information about the calculation of recoverable amount, including certain information about the sensitivity of recoverable amount to changes in the key assumptions on which management has based its determination of recoverable amount. The objective of those disclosures is to provide users with information that assists them in evaluating the reliability of the estimates used by management to support the carrying amounts of goodwill and identifiable intangible assets with indefinite useful lives.

The Board also tentatively agreed that the disclosures should be made for each primary segment (determine in accordance with IAS 14 *Segment Reporting*) containing goodwill or identifiable intangible assets with indefinite useful lives. However, the information should be disclosed separately for a cash-generating unit (or group of cash generating units) within a segment when:

- the amount of goodwill or identifiable intangible assets with indefinite useful lives allocated to that cash-generating unit (or group of cash-generating units) is significant in relation to the total amount of goodwill or identifiable intangible assets with indefinite useful lives, or
- either the basis for determining the recoverable amount of the cash-generating unit (or group of cash-generating units) or the nature or amount of the key assumptions on which management has based its determination of the recoverable amount of the cash-generating unit (or group of cash-generating units) vary widely from those used for the other cash-generating units (or groups of cash-generating units) within the segment.

Improvements to existing IASs

IAS 1 *Presentation of Financial Statements*

The Board agreed the following:

- To retain the provision in IAS 1 *Presentation of Financial Statements*, paragraph 13, permitting entities to depart from a requirement of a Standard in the extremely rare circumstances where management concludes that compliance with the requirement would be misleading and the departure is necessary to achieve a fair presentation. The Board agreed to strengthen the language of IAS 1 to emphasise the presumption that compliance with Standards results in fair presentation, to explain that fair presentation means faithful representation of transactions and events in accordance with the definitions and recognition criteria for the elements in financial statements in the IASB *Framework*, and to specify that departure from a requirement of a Standard is permitted only in unique circumstances.
- Not to include in the improvements proposals for IAS 1 additional disclosures concerning operational risk and capital recommended by the Board's Financial Activities Advisory Committee, which is reviewing IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*. The Board agreed to consider these disclosures in a future limited review of IAS 1 consequential to the Board's review of IAS 30.

IAS 16 *Property, Plant and Equipment*

The Board agreed the following:

- To require in IAS 16 *Property, Plant and Equipment* that a component approach to depreciation is applied to all items of property, plant and equipment. Under a component approach, each material component of a composite asset with a different useful life or different pattern of depreciation is accounted for separately for the purposes of recognising depreciation and accounting for subsequent expenditure (including expenditure on replacement or renewal of the component).
- To require in IAS 16 that all exchanges of items of property, plant and equipment be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably. In such a case, the cost of the asset acquired in the exchange is measured at the carrying amount of the asset given up. The Board agreed to specify a similar policy for exchanges of intangible assets in IAS 38 *Intangible Assets.* The Board agreed to emphasise in IAS 38 the importance—and the difficulty—of obtaining sufficient evidence to determine reliably the fair value of intangible assets exchanged. The Board also agreed that similar policies should not be specified for exchanges of

goods or services in IAS 18 *Revenue*, which should continue to prohibit the recognition of revenue from such exchanges.

- To require the accounting requirements (including depreciation requirements) in IAS 16 to be applied to all items of property, plant and equipment, regardless of whether the items are held for sale.
- To withdraw Interpretation SIC–6 *Costs of Modifying Existing Software* when IAS 16 is revised.

IAS 17 *Leases*

The Board considered a limited improvement to IAS 17 *Leases* and made the tentative decision described below. It should be noted that, in the light of the Board's wider project on leases, it has decided to propose only two changes to IAS 17 in the improvements project.

The Board decided to clarify that when classifying a lease of land and buildings, the lease should be split into two elements – a lease of land and a lease of buildings. The land element would be classified as an operating lease under paragraph 11 of IAS 17. The buildings element would be classified as an operating or finance lease by applying the normal conditions in IAS 17.

In the light of comments made at its meeting with partner national standard-setters, the Board reconfirmed the decision made at the December 2001 meeting on the treatment of initial direct costs incurred by lessors. This is that the present choice in IAS 17 should be eliminated and replaced by a requirement that such costs be capitalised and allocated over the lease term.

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

The Board decided to require that comparative amounts be translated as follows:

- For an entity whose functional currency is **not** the currency of a hyperinflationary economy:
  - Assets and liabilities in the comparative balance sheet are translated at the closing rate at the date of that balance sheet (that is, last year's comparatives are translated at last year's closing rate).
  - Income and expense items in the comparative income statement are translated at exchange rates at the dates of the transactions (that is, last year's comparatives are translated at last year's actual or average rate).
- For an entity whose functional currency **is** the currency of a hyperinflationary economy, and for which the comparative amounts are being translated into the currency of a hyperinflationary economy, all amounts (both balance sheet and income statement items) are translated at the closing rate of the most recent balance sheet presented (that is, last year's comparatives are translated at *this* year's closing rate).
- For an entity whose functional currency **is** the currency of a hyperinflationary economy, and for which the financial statements are being translated into the currency of a non-hyperinflationary economy, all comparative amounts are those presented in the prior year financial statements (that is, there is no adjustment for either subsequent changes in the price level or subsequent changes in exchange rates).

This translation method would apply both when translating the financial statements of a foreign operation for inclusion in the financial statements of the reporting entity, and when translating the financial statements of an entity into a different presentation currency.

IAS 23 *Borrowing costs*

In the light of comments made at its meeting with partner national standard-setters the Board re-debated whether to eliminate the choice in IAS 23 either to capitalise borrowing costs that meet certain conditions or to report all borrowing costs as an expense in the period they are incurred.

The Board noted, in particular, that many of the partner national standard-setters had suggested that this issue was best addressed in the context of a wider project on how to measure an asset on initial recognition. The Board will consider such a project as part of its regular evaluation of potential agenda topics.

In the light of these comments, the Board decided not to propose eliminating the choice in the improvements project.

IAS 40 *Investment Property*

The Board decided not to remove the present choice in IAS 40 of accounting for investment properties under either a fair value model or a cost model. It also decided to keep the matter under review, with a view to reconsidering the option to use the cost model in due course.

IAS 32 *Financial Instruments: Disclosure and Presentation*, and IAS 39 *Financial Instruments: Recognition and Measurement*

The Board discussed certain remaining issues in the project to amend IAS 32 and IAS 39, and agreed the following:

Portfolio assessments of impairment

- An asset that is individually identified as impaired should not be included in a group of assets that are collectively assessed for impairment.
- An asset that has been individually assessed for impairment and found not to be individually impaired should be included in a collective assessment of impairment. The occurrence of an event or a combination of events should not be a precondition for including an asset in a group of assets that are collectively evaluated for impairment.
- Assets should be grouped by similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms.
- Contractual cash flows and historical loss experience should provide the basis for estimating expected cash flow. Historical loss rates should be adjusted based on relevant observable data that reflect current economic conditions.
- The methodology for measuring impairment should ensure that an impairment loss is not recognised immediately on initial recognition. For the purposes of measuring impairment in groups of assets, estimated cash flows (contractual principal and interest payments adjusted for estimated credit losses) should be discounted using an effective interest rate that equates the present value of the estimated cash flows with the initial net carrying amount of those assets.

Accounting for derivatives on an entity's own shares

- A derivative that is indexed to the price of own shares and requires net cash or net share settlement, or gives the counterparty a choice of net cash or net share settlement, is a derivative asset or liability (not an equity instrument).
- A derivative that is indexed to the price of own shares and gives the entity a right to require net cash or net share settlement is a derivative asset or liability (not an equity instrument) unless the entity has an established history of settling such contracts through gross physical settlement.
- Changes in the fair value of a derivative that is fully indexed to the price of own shares and will result in the receipt or delivery of a fixed number of own shares in exchange for a fixed amount of cash should not be recognised in the financial statements.
- When a derivative involves an obligation to pay cash in exchange for receiving own shares, the entity recognises a liability for the share redemption amount.

Compound instruments with multiple embedded derivative features

- An issuer of a compound instrument with multiple embedded derivative features (such as a callable convertible bond) should disclose information about the existence of those features and the effective yield of that instrument.

Puttable instruments

- The key elements of the guidance in proposed final SIC Interpretation 34 *Financial Instruments – Instruments or Rights Redeemable by the Holder* should be incorporated into IAS 32. Thus, an issued instrument that involves a right for the holder to put the instrument back to the issuer for cash or another financial asset, the amount of which is determined based on an index or other item that has the potential to increase and decrease, is a liability.
- An entity that has no equity (such as an open-ended mutual fund or unit trust) may present a liability to repay a proportionate share of the net asset value of the entity as 'net asset value attributable to unit holders' on the face of the balance sheet and the change in the value of the liability as 'change in net asset value attributable to unit holders' on the face of the income statement.

Reporting performance

The Board discussed a concepts paper on reporting performance. The paper proposed a conceptual basis for the reporting performance project in the form of a series of eight principles. The Board was asked for provisional views (rather than final decisions) on these principles. After discussion, the following principles were accepted:

- The format of the performance statement should not be driven by concepts of realisation or recycling.
- The investors' perspective suggests that information relating to predicting the rate of change in financial statement items should be a key differentiator between performance statement components.
- A performance statement should be able to distinguish the return on total capital employed from the return on equity.
- It is not practical or meaningful to make a distinction between 'operating' and 'non-operating' on the basis that the former are 'core' or 'central' and the latter are not.
- A distinction between trading gains and holding gains encounters the same practical difficulties as the distinction between operating and non-operating activities. In addition, it introduces a time dimension as a second subjective basis of differentiation. The trading/holding distinction does not, therefore, suggest a clear-cut conceptual basis for income statement components.
- To the extent practically possible for net assets held at market values, a useful distinction can be made in the performance statement between expected income, unexpected income of the period, and unexpected capital gains or losses.
- To the extent possible, a performance statement should identify gains and losses where the change in economic value did not arise in the period in which it is reported.
- Within the prescribed format and without the use of proscribed sub totals, the performance statement should allow managerial discretion in business-specific reporting.

The Board broadly agreed to build on the eight principles as the basis of a set of working guides for performance reporting. It was noted that some ordering of the principles would be helpful, not least to distinguish those that clarify what not to do from those that offer prospective guidance.

The Board did not make a preliminary decision on whether to define a 'headline' performance statement sub-total, such as 'operating income' or 'pro forma earnings'. It was clear that further debate is needed, and that this would include further consideration of some of the principles.

Insurance contracts

The Board discussed illustrations of various approaches to accounting for a long-duration life insurance contract. The purpose of this discussion was educational and no decisions were taken.

At previous meetings, the Board had discussed chapter 3 of the Draft Statement of Principles (DSOP) prepared by the former IASC Insurance Steering Committee and available on the IASB's Website www.iasb.org.uk. Chapter 3 proposes that:

- insurance liabilities should be measured at entity-specific value while IAS 39 *Financial Instruments: Recognition and Measurement* is still in place, and
- if a successor standard to IAS 39 introduces fair value measurement for the substantial majority of financial assets and liabilities, the IASB should consider introducing fair value measurement for insurance liabilities.

The Board will not decide on this proposal until it has discussed chapters 4-6 of the DSOP. At this meeting, the Board discussed principles 4.3 – 4.11 of chapter 4 (estimating the amount and timing of future cash flows) and the whole of chapter 5 (risk and uncertainty). As a working hypothesis to guide its further work, the Board agreed in broad terms with the principles set out in chapters 4 and 5:

- The following future cash flows should not be included in determining the expected present value of future pre-tax cash flows arising from the closed book of insurance contracts:
    - income tax payments and receipts
    - cash flows arising from future insurance contracts
    - payments to and from reinsurers

- investment returns from current or future investments (except for certain performance-linked contracts, see chapter 7)
- cash flows between different components of the reporting entity.

- In determining entity-specific value, each cash flow scenario used to determine expected present value should be based on reasonable, supportable and explicit assumptions that:
  - reflect:
    - all future events, including changes in legislation and future technological change, that may affect future cash flows from the closed book of existing insurance contracts in that scenario;
    - inflation by estimating discount rates and cash flows either both in real terms (excluding general inflation, but including specific inflation) or both in nominal terms; and
    - all entity-specific future cash flows that would arise in that scenario for the current insurer, even cash flows that would not arise for other market participants if they took over the current insurer's rights and obligations under the insurance contract.
  - in relation to market assumptions, are consistent with current market prices and other market-derived data, unless there is reliable and well-documented evidence that current market experience and trends will not continue. Such evidence is likely to exist only if a single, objectively identifiable, event causes severe and short-lived disruption to market prices. In such exceptional cases, the assumptions should be based on this reliable evidence.
  - in relation to non-market assumptions, are consistent with the market assumptions discussed in the preceding bullet and with the most recent financial budgets/forecasts that have been approved by management. To the extent that those budgets and forecasts are not current and not intended as neutral estimates of future events, the insurer should adjust those assumptions. If the budgets and forecasts are deterministic, rather than stochastic, the entire package of scenarios should be consistent with the budgets and forecasts.
- When fair value is not observable directly in the market, fair value should be estimated by using the above principle, but with the following two differences:
  - fair value should not reflect entity-specific future cash flows that would not arise for other market participants if they took over the current insurer's rights and obligations under the insurance contract; and
  - if there is contrary data indicating that market participants would not use the same assumptions as the insurer, fair value should reflect that market information.
- The future cash flows used to determine entity-specific value or fair value should include overheads that can be directly attributed to a book of insurance contracts. (The Board noted the need to maintain consistency between this proposal and guidance on similar issues in other standards.) These overheads should include a reasonable charge for the consumption of all assets used to generate the cash flows concerned.
- The fair value of an insurance liability (insurance asset) should be determined without adding (deducting) transaction costs that would be incurred on a settlement (sale). For entity-specific value, transaction costs will not generally be relevant. However, if the insurer does expect to transfer the liability, any transaction costs that would be incurred on the transfer will be included in the estimated cost of handling claims.
- The entity-specific value of an insurance liability should not reflect the insurer's own credit standing. Conceptually, fair value should reflect the insurer's own credit standing, but this would have practical implications that need further investigation, in the Steering Committee's view. The Board noted that the treatment of an entity's own credit standing in measuring its liabilities raises wider issues that the Board will discuss as it follows up the proposals of the Joint Working Group.
- Until rights to recoveries qualify for recognition as an asset under the following paragraph, an insurer should:
  - include potential recoveries from salvage and subrogation in estimated future cash flows from existing insurance contracts; and
  - not recognise those rights to recoveries as separate assets.
- An insurer should recognise rights to recoveries, such as salvage rights and subrogation rights, as an asset when, and only when:
  - the insurer controls those rights, as a result of past events;
  - it is probable that the economic benefits associated with those rights will flow to the insurer; and
  - the insurer can measure those rights reliably. An insurer should measure those rights (including salvage property acquired by exercising those rights) at entity-specific value if insurance liabilities are measured at entity-specific value, and at fair value if insurance liabilities are measured at fair value.
- An insurer should not recognise catastrophe provisions relating to possible future claims beyond the end of the contracts included in the closed book. Similarly, an insurer should not recognise equalisation provisions to cover random fluctuations of claim expenses around the expected value of claims.
- An insurer should recognise acquisition costs as an expense when they are incurred.
- The entity-specific value and fair value of insurance liabilities and insurance assets should always reflect risk and uncertainty – preferably in the cash flows, or alternatively in the discount rate(s), without any double counting. The Board noted that a decision to reflect risk and uncertainty in the cash flows rather than in the discount rate might have disclosure implications.
- Estimates of both entity-specific value and fair value should reflect the market's risk preferences, inferred, as far as possible, from observable market data. Inferences about the market's risk preferences should be determined using a consistent methodology over time. Changes in the inferred level of risk preferences should be made only in response to observable market data. The Board noted that the proposal to use a consistent methodology over time should not discourage the adoption of improved methods as practice evolves.
- Option pricing models should be used to measure options and guarantees contained in insurance contracts. The Board

noted that insurers' experience of using such models in measuring insurance liabilities is limited at present.

- In the exceptional cases when no reliable estimate can be made of the market value margin at initial recognition of an insurance liability or insurance asset, an insurer should set the market value margin at a level that leads to no net underwriting profit or loss from the contract, until a reliable estimate of the market value margin becomes possible. The Board noted that there are different views on the reliability of estimates of market value margins, particularly for those risks for which the market's risk preferences are not readily observable.
- Both fair value and entity-specific value should exclude the effect of illiquidity and market imperfections, unless there is persuasive evidence that enables these items to be quantified by reference to observable market data.
- When all the future cash inflows and outflows from an insurance contract are denominated in a single foreign currency, the entity-specific value and fair value of that insurance contract should not reflect foreign currency risk arising from the possibility of future changes in the foreign exchange rate for that currency (consistent with IAS 21 *The Effects of Changes in Foreign Exchange Rates*). When future cash flows are in more than one currency, or where the policyholder can choose the currency in which premiums or benefits are paid, at a predetermined exchange rate, entity-specific value and fair value should reflect the resulting foreign exchange risk.

The Board discussed, but did not attempt to reach conclusions on, the following proposals in chapter 5:

- The entity-specific value or fair value of an insurance liability or insurance asset should always reflect both diversifiable and undiversifiable risk.
- Measurement of insurance contracts should focus on books of insurance contracts that are subject to substantially the same risks, rather than on individual insurance contracts. Measurement of the book of contracts should reflect all benefits of diversification and correlation within that book of contracts (to the extent that they are readily determinably), but should not reflect the benefits of diversification and correlation outside that book of contracts.

The Board will continue its discussion of the DSOP in February 2002.

Meeting dates: February – June 2002

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

18 – 22 February†

20 – 22 March – Tokyo, Japan

17 – 19 April

20 – 24 May‡

17 – 21 June – Berlin, Germany†

† Includes a meeting with Standards Advisory Council

‡ Includes a meeting with partner national standard-setters