

The International Accounting Standards Board met in London on 23-25 October 2002, when it discussed:

- Business combinations (phase II)
- Consolidation and special purpose entities
- Convergence of accounting standards
- Insurance contracts
- Linkage of transactions
- Revenue recognition
- Reporting performance

The IASB met its partner national standard-setters in London on 28 and 29 October. The group discussed:

- Convergence of accounting standards
- Leasing
- Measurement
- Reporting performance
- Research projects on extractive industries, intangible assets, narrative reporting, revaluation of tangible assets, service arrangements and small and medium-sized entities

No technical decisions were requested or made at this meeting. A full report of the group's discussions will be included in a forthcoming issue of *IASB Insight*.

## Business combinations (phase II)

### Report on US Financial Accounting Standards Board meeting of 25 September 2002

The Board considered a report on the FASB meeting of 25 September 2002, and noted the following tentative decisions made by the FASB at that meeting:

- The FASB agreed to reconsider whether certain issues should be included in the scope of this project. These issues include matters relating to the treatment in a business combination of:
  - Amendments to employee benefit plans that (1) are a condition of the business combination, or (2) are intended changes by the acquirer to employee benefit plans of the acquiree
  - Constructive obligations

- In-process research and development of the acquiree at the date of acquisition
- The FASB also agreed that it should address at the same time all issues relating to the accounting for and reporting of minority interests that are within the scope of the joint FASB and IASB project on purchase method procedures, and the FASB projects on liabilities and equity, and consolidations policy and procedures.

### Scope

#### Minority interest issues

The Board considered whether the scope of its Purchase Method Application project should be expanded to consider jointly with the FASB all issues associated with minority interests. The Board agreed to include in the scope of the project the following minority interests issues initially excluded from that scope:

- decreases in the parent's ownership interest after a business combination (both with and without loss of control)
- display of minority interests in the consolidated income statement or statement of changes in equity.

These issues will be addressed jointly with the FASB staff currently assigned to the joint Purchase Method Application project. The Board directed the staff to consider how all of the minority interests issues to be addressed jointly with the FASB should be divided among the IASB's active projects (Purchase Method Application project, Improvements project or Consolidation and Special-Purpose Entities project) for exposure or a final standard.

#### IFRIC agenda item

The Board considered the recommendation of the IFRIC Agenda Committee that the Board should address as part of its Purchase Method Application project the issues addressed in UK UITF Abstract 31—*Exchanges of businesses or other non-monetary assets for an interest in a subsidiary, joint venture or associate*. The specific

questions concerned the position where an entity, B, issues shares to another entity, A, in exchange for A's business or other non-monetary assets and as a result of this transaction becomes A's subsidiary, joint venture or associate. In such cases,

- should A's business or other non-monetary asset exchanged for an interest in a subsidiary, joint venture or associate be accounted for at fair value at the date of the transaction, at previous carrying amount or some combination of the two?
- how should A's gain or loss arising on the transaction be reported?

The Board agreed to address these issues for circumstances in which B becomes A's subsidiary. Transactions that are not business combinations may pose similar problems and will be addressed at a later date.

### Recognition and measurement issues related to acquired assets and assumed liabilities in a business combination – FASB specific issues

The Board considered the tentative decisions made by the FASB on the following issues that arise under US generally accepted accounting principles as a consequence of applying the working principle and the fair value hierarchy:

- the interaction of the fair value hierarchy with existing guidance on acquired trade, loan and other receivables *(continued...)*

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## Business combinations (phase II) (continued)

- whether this project should address the subsequent accounting for receivables and loans acquired in a business combination
- the interaction of the fair value hierarchy with existing guidance on assets held for sale
- how assets should be measured initially if their disposition after the business combination were a condition of the business combination, including conditions imposed by regulators
- the interaction of the fair value hierarchy with existing guidance on the initial unit of measure for intangible assets
- whether the FASB should provide additional guidance for applying the fair value hierarchy in the initial measurement of 'in-process' research and development (IPR&D)
- whether this project should address the subsequent accounting for IPR&D acquired in a business combination.

The Board agreed to provide the following application guidance for determining the fair value of acquired receivables consistently with that tentatively agreed by the FASB:

“Acquired receivables (including loans) would be measured at fair value at the date of acquisition; thus, a separate allowance for uncollectible amounts would not be established upon initial recognition of those receivables.”

The Board noted that there could be issues related to the interaction of the fair value working principle with the existing requirements and guidance in other IFRSs. However, the Board agreed that these issues do not justify a departure from the fair value working principle for the assets acquired and liabilities assumed in a business combination. Therefore, the Board agreed that it need not address the interaction of the fair value working principle with the existing guidance in other IFRSs. After the initial recognition and fair value measurement of the assets acquired and liabilities assumed, the acquirer would apply the requirements of other IFRSs to those items as appropriate.

## Consolidation and special purpose entities

The Board was presented with a summary of the FASB Roundtable on Consolidation of SPEs and the principal decisions made by the FASB in relation to this project at its meeting on 16 October 2002. The Board agreed to continue to monitor developments on the FASB project.

The Board then discussed various issues raised by staff in relation to the IASB's project on consolidations and SPEs and made the following tentative decisions:

- consolidation should be based on control. Where control cannot be assessed by looking at who has the power to direct financial and operating policies, control should be assessed by other means. (The latter situations are referred to below simplistically as 'SPEs').
- for non-SPEs, the equity interests of ordinary shareholders are usually the interests with the most variability of expected outcomes. Accordingly, for SPEs, the holder of those interests with a majority of the variability of expected outcomes is akin to a majority equity holder. The Board tentatively agreed that these are the parties who should consolidate SPEs.

- the notion of variable interests should be based on an assessment of potential variability in economic outcome.
- it was acknowledged that this approach might result in assets held indirectly via another entity being recognised that would not be recognised if the assets were held directly.
- a preference was expressed that there should be no specific exceptions for particular transaction types (such as particular securitisation transactions or 'qualifying' SPEs) because of the resulting complexity.
- the notion of variable interests is to be further developed by staff.
- the staff is to explore whether an appropriate interim solution would be for IFRIC to clarify SIC-12 to confirm that a 'majority' of benefits or risks (in SIC-12 10(c) and 10(d)) is intended to refer to exposure to the majority of the variability of expected economic outcome (rather than the absolute economic outcome).

## Convergence

### Standards applicable in 2005

The Board agreed that only the following current projects would result in standards, or amendment of existing standards, that would be effective for financial statements covering periods beginning on or after 1 January 2005:

- first-time application of IFRSs
- improvements – general
- improvements – financial instruments
- business combinations (phases I & II)
- share-based payment
- convergence (short-term strategy) and
- insurance (phase I)

It was noted that those areas where the short-term convergence project might affect the Improvements project would be considered as a matter of priority by the FASB and the IASB.

It was also noted that other standards and amendments to standards were expected to be issued during 2004 and 2005. It is intended that these standards and amendments would not have a mandatory application date until after 2005 but could be adopted early by entities that so wished. Projects in this category include:

- post-employment benefits
- performance reporting
- revenue and liabilities
- consolidations (including SPEs)
- segment reporting and
- deposit taking, lending and securities activities.

### Post-employment benefits

The Board discussed two issues:

- the expected return on plan assets
- the allocation of costs to periods of service.

#### *The expected return on plan assets*

IAS 19 *Employee Benefits* requires the total change in value of plan assets to be split into an expected return and the difference between the expected return and the actual return. The expected return is currently reported in income and the difference between the expected return and actual return is

treated as an actuarial gain or loss, the recognition of which is currently allowed to be deferred. The Board had previously agreed that there should be no deferral of actuarial gains and losses. The Board now further tentatively agreed that no expected return on plan assets should be presented separately. Instead, the total change in value of all plan assets should be presented in the proposed second, remeasurement, column of the statement of comprehensive income. It was agreed that the Board would reconsider this issue after its discussion of the net presentation/consolidation of the pension plan in the sponsor's balance sheet (planned for the November meeting).

#### *The allocation of costs to periods of service*

In order to determine the liability that exists at any balance sheet date, it is necessary to allocate the cost of benefits earned to each accounting period. For benefits that vest in the same period as they are granted, there is no issue – they are earned in that period. For benefits that vest over some future period, the requirements in IAS 19 for current service cost and past service cost are complex and inconsistent. The Board agreed that the cost of unvested benefits should be allocated between the grant date and the vesting date on a straight-line basis.

The recognition of benefits in this way would be based on the unit of benefit that has vested. The measurement of that unit of benefit will be based on the measurement requirements of IAS 19. So, for example, for a plan that provides no benefits for the first 19 years of service and a vested benefit of 10,000 for the 20th year, the benefit would be attributed on a straight-line basis over the 20 years to the vesting date. For a plan that provides for 1 per cent of final salary for each year of service, the vested unit of 1 per cent would be recognised each year and measured on a basis that reflects expected final salary, even though some of the benefit measured on that basis has not yet vested at the balance sheet date.

Finally, the Board agreed that any benefit allocated to the current period or past periods would be recognised immediately. This will result in no unrecognised past service cost relating to unvested benefits (as there can be under IAS 19). To the extent that increased benefits are allocated to past periods, their cost will be recognised immediately and to the extent that they are allocated to future periods, there is no effect on the liability at the balance sheet date and hence no past service cost to recognise.

## **Linkage**

The Board discussed the issue of 'linkage', ie when the accounting treatment for two or more transactions or contracts differs depending on whether the contracts are accounted for separately or together.

The Board noted that the issue of linkage is relevant to a number of Board projects that will be discussed in the next few months, including revenue recognition, derecognition, the distinction between debt and equity and fair value vs cost (the latter three are all relevant to finalising the proposed improvements to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*).

The Board noted that the issue of linkage can be seen as how to interpret the principle in the *Framework* that transactions should be accounted for in accordance with their substance and economic reality and not merely their legal form. Whilst it is usually appropriate to account for transactions individually, there is a need to assess the combined effect of the transactions where the measurement or terms of transactions are interdependent.

The Board discussed a number of examples in which issues of linkage arise. It tentatively agreed that in some cases a notion of linkage was not needed to get to the accounting treatment it considered appropriate. However, in other cases, a notion of linkage would be useful.

The Board agreed that the IFRIC should continue to consider the issue of linkage. When it had developed its proposals further, it should consult the Board. The Board might address linkage in a number of ways – perhaps as an amendment to IAS 32, IAS 1 *Presentation of Financial Statements* or [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, or when revising the *Framework*. Alternatively, it might ask the IFRIC to develop an interpretation as an interim measure, to be incorporated into future revisions to standards and/or the *Framework* in due course.

## **Insurance contracts (phase I)**

The Board discussed:

- the definition of insurance contracts for phase I of the project
- exclusions from the scope of phase I
- recognition and measurement of insurance contracts for phase I.

### **Definition of insurance contract**

The Board tentatively agreed that an insurance contract should be defined as “a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.”

The Board discussed a preliminary draft of guidance to support the proposed definition. Among other things, this draft guidance states that:

- insurance risk is risk other than financial risk. Financial risk is the risk of a possible future change in one or more of a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable.
- insurance risk is significant if, and only if, there is a reasonable possibility that an event affecting the policyholder or other beneficiary will cause a significant change in the present value of the insurer's net cash flows arising from that contract. In considering whether insurance risk is significant, it is necessary to consider both the probability of the event and the magnitude of its effect.
- a contract that qualifies as an insurance contract at inception remains an insurance contract until all rights and obligations are extinguished or expire (even if a significant change in the present value of the insurer's net cash flows is no longer a reasonable possibility). Conversely, if a contract does not qualify as an insurance contract at inception, it should be subsequently reclassified as an insurance contract if a significant change in the present value of the insurer's net cash flows becomes a reasonable possibility.

The Board agreed:

- to use this definition of insurance contracts throughout IFRSs
- to change all scope exclusions in IFRSs that refer to 'insurance entities' to 'insurance contracts' (for example in the scope exclusions contained in IAS 18 *Revenue*, IAS 32 *Financial Instruments: Disclosure and Presentation*, IAS 37 *Provisions, Contingent Liabilities and Contingent*

*Assets, IAS 38 Intangible Assets and IAS 39 Financial Instruments: Recognition and Measurement*)

- to define a reinsurance contract as an insurance contract issued by one insurer (the reinsurer) to indemnify another insurer (the cedant) against losses on an insurance contract issued by the cedant
- to remove from IAS 32 and IAS 39 the scope exclusion for derivatives based on climatic, geological, or other physical variables. Such contracts would then be subject to the IFRS on insurance contracts if payment is contingent on an uncertain future event that adversely affects the contract holder, and subject to IAS 39 in other cases.

### Scope exclusions

Some or all of the following items arise under contracts that may meet the proposed definition of insurance contracts, but are also covered by other IFRSs. The Board agreed to exclude them from the scope of the insurance contracts IFRS for phase I:

- product warranties issued directly by a manufacturer, dealer or retailer
- employers' assets and liabilities under employee benefit plans (including equity compensation plans), and retirement benefit obligations reported by defined benefit retirement benefit plans
- contingent consideration payable or receivable in a business combination
- contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease
- contracts for which the issuer would be permitted or required to settle its obligations by acquiring new financial liabilities or equity instruments to be issued by the holder of the contract if the insured event occurs.

The staff will research whether scope exclusions are needed for:

- financial guarantees (including insurance that covers credit risk)
- contracts for which the issuer would be permitted or required to settle its obligations by issuing equity instruments as defined in IAS 32.

### Recognition and measurement

Paragraphs 5 and 6 of [draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria that an entity should use in developing an accounting policy if no IFRS or Interpretation applies specifically to an item. The Board agreed that phase I should temporarily exempt an entity that issues insurance contracts from applying those criteria to:

- insurance contracts issued by the entity
- reinsurance contracts issued to the entity.

However, an entity should apply those paragraphs to all its other assets and liabilities for which no IFRS or Interpretation applies specifically. Furthermore, an entity should apply those paragraphs to direct insurance contracts issued to it by another entity.

The temporary exemption from the application of paragraphs 5 and 6 of [draft] IAS 8 is intended as a practical concession for a short period only. The Board reaffirmed its commitment to completing phase II without delay.

Paragraph 9 of [draft] IAS 8 prohibits a change in accounting policies, unless the change will result in a more relevant and reliable presentation. The Board agreed that the phase I IFRS should include robust guidance to help insurers assess whether a presentation is more relevant and reliable.

### Proposed changes for phase I

The Board agreed that:

- an insurer should not recognise (i) catastrophe provisions relating to possible future claims beyond the end of the contracts included in the closed book or (ii) equalisation provisions to cover random fluctuations of claim expenses around the expected value of claims.
- phase I should include a loss recognition test that would apply if an insurer's existing accounting policies do not require the immediate recognition of a loss when current estimates of future cash flows indicate the existence of a loss. If the insurer's accounting policies do not require the recognition of a loss in such cases, the insurer should increase the carrying amount of the liability in question to the amount that would be required under IAS 37. The staff will develop more detailed proposals.
- offsetting reinsurance assets against the related direct insurance liabilities would be prohibited.
- an insurer should not change the measurement basis for its insurance liabilities when it buys reinsurance. An example of a change in measurement basis is a change from an undiscounted basis to a discounted basis.

The staff will investigate whether there are any reasons to set derecognition principles for insurance contracts that differ from those used for financial instruments under IAS 39. If no such reasons emerge, the staff will recommend that phase I require the same derecognition principles as IAS 39. If reasons do emerge that require further investigation, addressing derecognition of insurance contracts may have to wait until phase II.

### Continuation of some existing practices in phase I

The Board also agreed that phase I should not:

- require discounting
- try to define or eliminate excessive prudence
- preclude an insurer from continuing to use embedded value in its primary statements
- require an insurer to use uniform accounting policies for the insurance liabilities of all its subsidiaries, as would be required under [draft] IAS 27 *Consolidated and Separate Financial Statements*. The staff will investigate the need for disaggregated disclosure if an insurer's accounting policies are not uniform.

However, the Board decided that phase I should prohibit an insurer to change its accounting policies (either on first-time application of IFRSs or once it applies IFRSs) in a way that (i) switches from discounting to not discounting (ii) creates or increases excessive provisions (iii) includes future investment margins or (iv) switches from uniform to non-uniform accounting policies for the insurance liabilities of its subsidiaries. In the Board's view, such changes would not result in a more relevant and reliable presentation—and would thus, as noted above, be inconsistent with paragraph 9 of [draft] IAS 8.

### Areas not addressed in phase I

The Board agreed that phase I should not:

- prohibit or require the deferral of acquisition costs or prescribe what acquisition costs are deferrable, prescribe the period and method of their amortisation or whether an

insurer should present deferred acquisition costs as an asset or as a reduction in insurance liabilities. (The Board will discuss in a later meeting the treatment under IAS 39 of transaction costs for contracts that are not insurance contracts.)

- require specific methods for dealing with embedded insurance options that do not contain financial components such as interest rate guarantees. A later meeting will address (i) embedded financial options such as interest rate guarantees and (ii) embedded options that contain both insurance and financial components.
- address special purpose entities (SPEs) used by insurers. The Board has a separate project on consolidation and SPEs.
- address salvage and subrogation, or amend the existing requirements in IAS 37 for expected disposals of assets and reimbursements; or
- specify whether an insurer should present policy loans as a deduction from the related insurance liability or as a financial asset.

## Reporting performance

The Board discussed specific issues relating to the proposed columnar distinction in the statement of comprehensive income. Except where noted, these decisions are made within the constraints of the recognition, measurement and disclosure requirements of existing IASs.

The Board reached a tentative conclusion on the following presentations (note that *comprehensive income* is equal to the sum of two totals: the total ‘income flows’, which are reported in the first column in the proposed statement, and the total ‘valuation adjustments’, which are reported in the proposed second column).

- *Employee benefits.* Service cost and past service cost (arising on plan amendments) are income flows, as both arise on initial recognition. Interest costs are also income flows because they arise from the passage of time. In contrast, actuarial gains/losses on obligations and plan settlements and curtailments are revisions to prices or estimates and so should be reported as valuation adjustments.
- *Share-based payment.* All expenses result from the recognition of goods and services received and are therefore income flows, with the exception of revisions to the fair value of the liability (in cases where a liability is recognised) and to any deferred tax asset.
- *Non-equity financial assets and liabilities.* Interest income and expenses determined and reported in accordance with IAS 39 are income flows, while all other income and expenses are valuation adjustments.
- *Provisions.* The initial recognition of a provision and subsequent interest costs (including the unwinding of a discount) are both income flows, while remeasurements of the liability due to changes in the original estimates are valuation adjustments. In this context, ‘initial recognition’ includes changes in a provision as the result of recognition of a new liability. An example is when an environmental provision is increased as a result of additional usage.
- *Tangible fixed assets.* Depreciation is an income flow, while impairments, revaluations and disposal gains/losses are valuation adjustments.
- *Investment property.* Rent is an income flow, whereas changes in property values are valuation adjustments.

- *Goodwill.* The impairment of goodwill is a valuation adjustment.
- *Inventory.* The impairment of inventory, as recognised under IAS 2 *Inventories*, is a valuation adjustment.
- *Inventories of agricultural assets.* The Board noted that IAS 41 *Agriculture* encourages, but does not require, the separation of value changes arising from physical changes in assets over time (which should be reported as income flows) from changes in estimated fair values for a given asset between points in time (which should be reported as valuation adjustments). The Board discussed whether the encouragement in IAS 41 should be made a requirement. The staff will explore this possibility.
- *Investment in equity instruments.* The Board noted that, under IAS 18 *Revenue*, dividend income is a component of revenue. However, the Board also noted that dividend income is a realisation of a part of the value change in equities, and it is not an income flow analogous to the interest earned on a debt instrument during a period. The Board concluded that the total value change for equity instruments cannot be disaggregated satisfactorily and a provisional decision was made that the whole of the value change including any dividends received should be reported as a valuation adjustment.
- *Financial assets and liabilities held-for-trading.* Such financial assets and liabilities should not be treated differently from other financial instruments. As there is no requirement in IAS 39 to report dividends or interest separately from fair value changes the entire amount could be reported as a valuation adjustment.
- *Foreign exchange gains and losses.* The foreign currency translation gain/loss arising on the remeasurement of an entity’s investment in the net assets of subsidiaries should be reported as a valuation adjustment.

## Revenue recognition

The Board considered a preliminary set of ‘working criteria’ for recognising revenue that focus on changes in assets and liabilities. The Board generally agreed with the working criteria and will test them in future discussions of case studies.

The Board noted that the proposal that an increase in equity is an essential characteristic of revenue needs to be clarified before the Board decides whether to adopt it. Its primary concern is that when the carrying amounts of some assets sold equal or exceed the value of the assets obtained in return, it may be concluded that an increase in equity has not occurred and no revenue should be recognised. In addition, the Board tentatively agreed:

- not to include aspects of the definitions of assets and liabilities in the definition of revenue; and
- not to specify the measurement attribute for initial recognition of assets and liabilities arising from a revenue-generating arrangement, until it develops measurement concepts for the IASB *Framework*.

The Board plans to begin discussing revenue recognition case studies using the working criteria at its November meeting.

### Meeting dates: November – December 2002

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

12 – 16 November, Hong Kong SAR, China<sup>†</sup>

18 – 20 December

<sup>†</sup> Includes a meeting with the Standards Advisory Council