BOARD DECISIONS ON INTERNATIONAL ACCOUNTING STANDARDS

IASB UPDATE

September 2002

The International Accounting Standards Board met in Norwalk, Connecticut, USA on 17, 19 and 20 September 2002, when it discussed:

- Business combinations (phase II)
- Convergence of accounting standards
- IFRIC matters
- Insurance contracts
- Reporting performance
- Share-based payment.

In addition, the IASB met the US Financial Accounting Standards Board on 18 September 2002, when the two Boards discussed:

- Convergence of accounting standards
- Reporting performance
- Business combinations (application of the purchase method)
- Revenue and liability recognition.

Educational joint Board meeting with the US Financial Accounting Standards Board

The IASB and the FASB met on 18 September 2002 and discussed the following projects. The meeting was informational and no decisions were made.

Convergence

The Boards discussed their strategies for achieving and maintaining consistency between FASB and IASB standards. Among the issues discussed were strategies for resolving existing differences and for mitigating the potential for divergence in any future projects. Although no formal decisions were made, the Boards (i) affirmed their commitment to achieving convergence of accounting standards, (ii) expressed general support for a proposed short-term project, the objective of which would be to eliminate many existing differences between FASB and IASB accounting standards (the FASB will consider adding such a project to its agenda on 2 October 2002) and (iii) expressed general support for coordinating their technical agendas so as to avoid creating differences.

Financial performance reporting by business enterprises

The Boards discussed their respective projects on reporting financial performance and the decisions each had taken. The discussion was focused on the basis for making two primary classifications for the display of items (components) on the face of the statement of comprehensive income. Those distinctions are tentatively referred to as *financing* and *operating*, and *income flows* and *valuation adjustments*. Members of each Board expressed support for further development of the definitions or descriptions for making those distinctions and the need to learn more about the ability to implement those distinctions. The Boards also discussed the decisions that each had made, focusing on the reasons underlying them where the Boards diverged. Each of the Boards encouraged their staff to work on defining key terms and to continue cooperative efforts on the project.

Business combinations (phase II)

The Boards discussed their progress and plans for their joint project on purchase method procedures/application. They had reached consistent decisions on the fundamental working principle and other major issues but diverged on certain issues. The discussion focused on gaining a fuller understanding of the underlying reasons for those differences, including identifying (i) differences that arise as a consequence of existing guidance on matters other than business combinations and (ii) differences for which there may be opportunities to reconcile the views of the Boards. The issues discussed included:

- whether to provide specific guidance for the initial measurement of the fair value of certain acquired assets and assumed liabilities (for example, selection of a market price when applying the fair value hierarchy if multiple markets exist)
- the measurement date for equity instruments issued as consideration
- the basis for measuring assets held for disposal
- the accounting for amendments to the acquiree's employee benefit plans that are a condition of the business combination or are intended changes by the acquirer to the acquiree's plan, as well as project scope decisions related to employee benefits.

The Boards also discussed their next steps for the joint project, including plans for addressing remaining issues (such as matters related to non-controlling interests in an acquired entity) and timing for their Exposure Drafts.

Revenue recognition

The Boards considered pursuing their revenue recognition projects jointly. They discussed administrative matters relating to the joint project and shortcomings of the existing conceptual criteria for revenue recognition. They also discussed examples illustrating the differences between a revenue recognition approach that focuses on changes in assets and liabilities (consistent with FASB Concepts Statement No. 6, *Elements of Financial Statements*, and the definition of income in the IASB *Framework for the Preparation and Presentation of Financial Statements*) and an approach that focuses on an earnings process that overrides changes in assets and liabilities (consistent with FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, and the acknowledgement in the IASB *Framework* that being earned is an application of its recognition criteria). The Boards directed the staff to explore the use of an approach that was focused on changes in assets and liabilities.

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

IASB Publications Department,
Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7332 2749
E-mail: publications@iasb.org.uk
ISSN 1474-2675

IASB Meeting

Business combinations (phase II)

The Board considered the issues upon which the Board's conclusions and the FASB's have yet to converge in their respective business combinations projects. The consideration followed discussion of these issues at the IASB/FASB joint meeting on 18 September 2002.

Measurement date for equity instruments issued as consideration

The Board reconsidered the measurement date for equity instruments issued as consideration in a business combination and agreed that there were valid arguments for measuring them at the agreement date or the acquisition date. However, in the interests of convergence, the Board agreed that the equity instruments should be measured at the instruments' fair value at the acquisition date, ie the date on which control over the acquiree is transferred to the acquirer.

Comparison of IASB and FASB conclusions in phases I and II

The Board noted that some of the issues on which convergence had yet to be achieved arise as a consequence of existing guidance on matters other than business combinations. These 'inherited' differences need to be considered by the Board and the FASB in future projects that address directly the sources of the issues (for example, in a project on impairment). The Board noted that some of these differences might be addressed in the Convergence project.

Fair value measurement issues related to acquired assets and assumed liabilities in a business combination

In June 2002 the FASB and the IASB agreed to hierarchical guidance for determining the initial fair values to be recognised at the date of acquisition for identifiable assets acquired and liabilities assumed in a business combination.

The Board considered the implications of this hierarchy for determining the fair value of inventory (including work in progress) and property, plant and equipment. The Board concluded that it was necessary for fair value to be determined for all identifiable assets by focusing on their place and condition and assessing the amounts for which they would be exchanged between willing buyers and sellers in the absence of a business combination, given those characteristics. The Board did not wish to explore, at a detailed level, how entities might, for these or other assets, work from prices of assets at other places or in different conditions (for example, by working backwards or forwards from retail or wholesale prices).

The role of credit risk in determining the fair value of a liability

The Board considered whether, to ensure proper application of the fair value hierarchy, application guidance should be provided in the IFRS on business combinations to clarify explicitly that, on initial recognition, the fair value of a liability assumed in a business combination reflects the credit risk applicable to that liability.

The Board decided that the application guidance tentatively agreed on by the Board at its meeting in July 2002 should be amended as follows (new text underlined):

"<u>The fair value of a liability assumed in a business combination reflects the credit risk applicable to that liability. The credit rating of that liability will impound the extent to which marketplace participants believe it has been altered by the business combination.</u> The determination of the fair value of the liability assumed should, therefore, be based on prices observed in recent market transactions for liabilities with a credit risk similar to that of the liability assumed at the date of acquisition. If market prices are not observable, the fair value of liabilities assumed should be estimated using valuation techniques. These techniques should incorporate the appropriate discount rate relevant to the credit risk applicable to the liability at the date of acquisition."

Convergence

The Board agreed to add to its active agenda a short-term joint project with the FASB aimed at eliminating those differences between IASB and FASB standards that might be capable of resolution in a relatively short time because a high quality solution is available from existing international and national accounting standards. It also resolved to work on a range of individual projects in the medium term that would reduce further those differences. Finally, it agreed to coordinate with the FASB the addition of future matters to their agendas.

Short-term convergence project

In relation to the short-term project, the Board agreed to consider, together with the FASB, each of the possible convergence topics. If convergence in the short term on any particular matter proved to be too difficult, consideration of the topic would be deferred to a discrete project.

- reduction of differences arising from proposals in the IASB Improvements project (to be led by the FASB, providing input to the IASB's redeliberation of the Improvements project):
  - *Classification of liabilities on refinancing* – [Draft] IAS 1 *Presentation of Financial Statements* would require liabilities to be classified as current unless the refinancing is complete by the balance sheet date. This reflects the principle that the balance sheet should reflect the contractual arrangements in force at the balance sheet date. Under US GAAP, liabilities are classified as non-current if the refinancing is complete by the date of issue of the financial statements.
  - *Classification of liabilities on breach of borrowing agreement* – Using the same principle as above, [Draft] IAS 1 would require such liabilities to be classified as current even if the lender had agreed not to demand repayment before the issue of the financial statements. Under US GAAP, they would be classified as non-current if the lender had agreed before the issue of the financial statements not to demand repayment for more than one year from the balance sheet date.
  - *Asset exchanges* – [Draft] IAS 16 *Property, Plant and Equipment* would require a gain or loss to be recognised on the exchange of similar assets based on fair value. This reflects the view that the recognition of income from an exchange of assets should not depend on whether the assets exchanged are similar. US GAAP does not recognise a gain on the exchange of similar productive assets.
  - *Voluntary change in accounting policies* – [Draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* proposes that voluntary changes in

accounting policy should be treated retrospectively. The IASB concluded that this was preferable to a cumulative adjustment in the year of change because the profit or loss for the period does not include effects of changes in accounting policies relating to prior periods and the comparative information is presented on the same basis as the current period. US GAAP generally requires a cumulative adjustment in the year of change.

  - *Improvements to IAS 32 and IAS 39 on financial instruments* – Many of the changes proposed in the improvements to IAS 32 and IAS 39 reduce differences between IASB and FASB standards. However, some of the proposed changes will create differences. It is acknowledged that some of the differences between IASB and FASB standards on financial instruments will have to form the subject of a longer-term major project, but some may be capable of resolution in the short term.
  - *Transitional requirements* – Different transitional requirements and effective dates for standards can lead to accounting differences that last for many years. The IASB has formulated its general approach to transitional arrangements in its Improvements project and in its project on first-time application of IFRSs.
- reduction of differences between FASB and IASB standards arising from relatively recently issued FASB statements (to be led by the IASB, providing input to both IASB and FASB):
  - *discontinued activities* – the FASB changed the definition of discontinued activities in Statement 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*. The IASB would consider eliminating or reducing differences between FAS 144 and IAS 35 *Discontinuing Operations* in relation to the definition of discontinued activities and, hence, the timing of any remeasurement and presentation.
  - *accounting for costs associated with exit or disposal activities* – FAS 146 *Accounting for Costs Associated with Exit or Disposal Activities* requires costs associated with exit or disposal activities to be recognised when the liability is incurred and gives guidance on the timing of recognition. Although FAS 146 is broadly consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, there are certain differences that the IASB will consider.
  - *government grants* - The IASB is conscious that IAS 20 *Government Grants and Disclosure of Government Assistance* is out of date and should be reviewed in the light of FASB Statement No. 116 *Accounting for Contributions Received and Made* and the joint revenue project.
- reduction of other differences between FASB and IASB standards (to be co-led, resulting in proposals from both the IASB and the FASB):
  - inventories – idle capacity and spoilage
  - accounting policies, changes in accounting estimates and errors
  - depreciation on assets held for disposal or idle assets
  - income taxes – application of the temporary difference approach
  - construction contracts (this would provide interim guidance pending completion of the revenue project – see joint meeting report, above)
  - hyperinflationary economies
  - joint ventures – definitions and proportionate consolidation method
  - interim financial reporting.

Post-employment benefits

In determining the scope of the convergence project on this topic, the Board confirmed that the following differences between IAS 19 *Employee Benefits* and the related FASB standards need not be considered by the IASB:

- *Measurement of plan assets for the calculation of the expected return on assets:* IAS 19 requires plan assets to be measured at fair value at the balance sheet date; FASB standards permit market values to be averaged over a period of up to five years.
- *The measurement date:* under IAS 19 the plan assets and plan liabilities must be measured at the balance sheet date; under FASB standards they can be measured up to three months before the balance sheet date.
- *Recognition of vested past service cost:* IAS 19 requires past service cost to be recognised over the vesting period. If the benefits vest immediately, the cost is recognised immediately. FASB standards permit the cost (for vested and unvested benefits) to be spread forward over the service lives of the employees. The recognition of unvested past service cost will be considered, together with the allocation of benefits to periods of service generally, at a later Board meeting.
- *Settlements and curtailments:* IAS 19 requires the gain or loss on settlements and curtailments to be recognised immediately. Under FASB standards there are complex rules that allow for some deferral.
- *Recognition of an additional minimum liability:* FASB standards require the recognition of at least the unfunded accumulated benefit obligation for pensions. The accumulated benefit obligation is based on current salaries and excludes the effect of deferring certain past service cost and actuarial gains and losses. If the minimum liability exceeds the obligation based on the normal projected salary basis, the excess is recognised as an additional liability with the corresponding debit entry being an intangible asset to the extent of any unamortised past service cost and a direct deduction from equity thereafter. IAS 19 does not require the recognition of an additional minimum liability.

The Board agreed to consider further the following items for inclusion in the scope of the project:

- the split of the total return on plan assets between an expected return set at the beginning of the period and an unexpected element
- whether the plan assets and plan liabilities should be reported gross rather than net in the entity's balance sheet
- additional disclosure about the plan assets (depending on the outcome of the above matters).

The Board considered whether there should be a limit on the amount that can be recognised as an asset in respect of a surplus in a defined benefit plan. It agreed that the principle to be followed was that the entity should recognise as an asset the rights the entity has to benefit from the surplus. In measuring those rights, the following hierarchy should be followed:

- value the entity's rights to refunds and reductions in future contributions. If this is less than the surplus, then
- value the entity's rights to fund increased benefits to current and future employees. No value should be ascribed to the entity's right to fund increased benefits to past employees. If these two items together are less than the surplus, then

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- value the entity's right not to fund future losses in the plan to the extent that the losses will be absorbed by the surplus.

IAS 19 *Employee Benefits*

The Board considered the differences between the guidance provided in IAS 19 and FAS 106 *Employers' Accounting for Postretirement Benefits Other Than Pensions* and decided:

- to include in an appendix or implementation guidance to IAS 19 guidance on the identification of a substantive non-pension post-employment benefit plan similar to the guidance in FAS 106
- to include in an appendix or implementation guidance to IAS 19 guidance on the selection of assumptions unique to health care post-employment benefit plans similar to the requirements and guidance in FAS 106, to the extent that the requirements and guidance in FAS 106 do not conflict with IAS 19
- to amend IAS 19 to require the recognition of potential changes in state health care benefits where the state benefits have been 'substantively enacted' (rather than the present requirement for reliable prediction), similar to the requirements of IAS 12 *Income Taxes*
- to require an analysis of the sensitivity of health care post-employment benefit plans to changes in the assumed health care cost trend rates
- to review whether the sensitivity of other post-employment benefits plans to key assumptions such as inflation should be disclosed in accordance with the proposals in [Draft] IAS 1 *Presentation of Financial Statements*
- to require the separate disclosure of post-employment benefit plans where the plans are subject to materially different risks, instead of the present encouragement of such disclosures.

IFRIC matters

The Board noted the matters considered by the International Financial Reporting Interpretations Committee at its meetings in July and August 2002. It also discussed the difficulty faced by the IFRIC in discussing issues that did not fall within the scope of various projects of the Board, concluding that judgements would be needed about the likely longevity of any interpretations to be attempted. A likely period of two years or more may justify the IFRIC in proceeding to address an issue.

The Board also reconsidered the role of the IFRIC in 'fatal flaw' reviews of IASB documents and concluded that such reviews should be restricted to final standards. This reflected the Board's desire to streamline the process for finalising exposure drafts. It was noted that the availability of decision summaries and open Board meetings provided the opportunity for accounting firms represented on the IFRIC and others to continue to make comments outside the formal due process as well as commenting on the exposure draft. The Board recognised that the IFRIC had been very responsive in providing comments on draft exposure drafts and that a number of its comments had resulted in amendments. However, it was also noted that the role played by the IFRIC in this regard did not constitute a fatal flaw review – it was more in the nature of additional exposure to that obtained from national standard-setters and from formal exposure. The aggregate amount of these exposures was considered to be too burdensome and should be reduced.

The Board noted that a paper is to be provided to it shortly on matters discussed by the IFRIC, including the role of economic compulsion when classifying financial instruments between debt and equity and the possible consequences of classifying minority interests as equity.

Insurance contracts

In May 2002, the Board decided to split the project on insurance contracts into two phases, to enable insurers to implement phase I by 2005. At this meeting, the Board discussed the approach and agreed that phase I should include the following components of the project:

- presentation and disclosure, including consideration of how insurers might give the disclosures about measurement assumptions proposed in [Draft] IAS 1 *Presentation of Financial Statements*
- elimination of a limited number of existing practices that are incompatible with the IASB *Framework*, for example, the elimination of catastrophe and equalisation provisions that do not represent liabilities as defined in the *Framework*
- a review of the implications for entities issuing insurance contracts of the hierarchy of pronouncements that an entity is required to consider in the absence of an IFRS that specifically applies to an item (see [Draft] IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, paragraphs 5 and 6). The Board will consider exempting insurance *contracts* temporarily from this requirement, provided that phase II proceeds without delay. All other IFRSs and the hierarchy will apply to entities that issue such contracts (beyond the scope exclusions for insurance contracts in existing IFRSs such as 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*).

In addition, the Board would consider how best to approach the application of IAS 39 to some contracts issued by insurers that do not qualify as insurance contracts for accounting purposes. Some contracts contain features (for example, renewal and cancellation options and participation features) that the Board would need to address in phase II because they are found in many insurance contracts. The Board noted that these features were also found in some contracts issued by financial institutions that are not insurers. In addition, many insurance contracts contain embedded options, and the staff will present an analysis of issues arising from these options at a future meeting.

The staff agreed to conform definitions and scope exemptions related to insurance contracts throughout IFRSs and will investigate whether it is also feasible to deal in phase I with the derecognition of insurance contracts.

Under existing national accounting practices, many insurers report deferred acquisition costs as an asset. The Board noted that such items are not excluded from the scope of IAS 36 *Impairment of Assets* and are therefore subject to impairment testing under IAS 36. The Board agreed to clarify that such items are included in the scope of IAS 36.

The Board agreed that accounting by policyholders for insurance contracts is not a high priority and should not be included in phase I unless time permits.

The Board will seek feedback on the proposed approach to phase I from its Advisory Committee for this project, which meets on 23 and 24 September.

The Board also considered a detailed report on field visits carried out by Board members and staff.

Reporting performance

The Board discussed implementation issues concerning the financing category of the statement of comprehensive income.

The Board reached tentative conclusions that:

- the financing category of the statement of comprehensive income should report all interest expenses/unwinding of discount rates arising on all liabilities. This follows from ‘financing’ being expenses arising from the passage of time when settlement is deferred. All liabilities provide finance to the entity because all involve deferred settlement of the entity’s obligations.
- there would be no need to go beyond the requirements of existing standards in measuring financing expenses.
- the financing category of the statement of comprehensive income should not include interest income. This is because such income is available to liability and equity claimants. In reaching this decision, the Board noted that an entity’s treasury function generally manages assets as well as liabilities, but that the financing category will relate only to liabilities. A related concern arises from the close relation between pension assets and pension obligations. Therefore, the Board decided that income arising on financial assets should be reported separately within the ‘operating/ business’ section of the statement of comprehensive income. The Board will discuss at a future meeting the implications of this decision for the presentation of income and expenses by function or by nature.
- given the decisions above, there was no need for the concept of ‘net debt’.

Share-based payment

The Board discussed various issues that have arisen during the process of drafting the Exposure Draft, as follows:

- the Board discussed and confirmed its earlier tentative decision that, to calculate the deemed fair value per unit of employee service received during the vesting period, the fair value of the equity instruments granted should be divided by the number of units of service expected to be received, as estimated at grant date. The Board also discussed and rejected an alternative method based on allocating the amount of expected benefits at grant date, but agreed that respondents to the ED should be asked for comments on both methods. The Board also agreed that the Appendix to the ED should include illustrative examples of an option or share grant with performance conditions.
- the Board discussed and confirmed its earlier tentative decision that all the tax effects of share-based payment transactions should be recognised in the income statement.
- the Board tentatively agreed to drafting changes to the scope of the ED and the proposed consequential amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* to clarify which standard applies in particular situations.
- the Board tentatively agreed that entities applying the IFRS for the first time (either on its effective date or on first-time application of IFRSs) should be permitted to measure existing liabilities for vested share appreciation rights (and other similar liabilities) at intrinsic value rather than fair value.
- the Board discussed and confirmed its earlier tentative decision that if a share or option grant is cancelled or repurchased during the vesting period (other than individual cancellations caused by the departure of employees), the entity should continue to account for services received during the vesting period, using the grant date, fair value measurement method. The Board also agreed to some drafting changes to the ED, to deal with situations in which an entity makes a cash payment as well as granting replacement shares or options upon the cancellation of unvested shares or options, and situations in which an entity repurchases vested options or other vested equity instruments.
- the Board tentatively agreed that the scope of the ED should include situations in which a shareholder transfers equity instruments direct to the employees (or other parties who have supplied goods or services to the entity), including equity instruments of the entity, the parent entity, or another entity within the group.
- the Board confirmed its earlier tentative decision that a reload feature should be taken into account when measuring the fair value of options granted, if it is not impracticable; if it is not impracticable to do so, any reload options subsequently granted should be accounted for as a new option grant.
- the Board tentatively agreed that the scope of the ED should include all types of goods, including inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. The Board also tentatively agreed to minor consequential amendments to other standards, for example, IAS 16 *Property, Plant and Equipment*, so that the measurement principles in the IFRS on share-based payment are applied to non-financial assets acquired in a share-based payment transaction.
- the Board tentatively agreed that, with respect to employee services received, because of the practical difficulties of measuring reliably the fair value of those services, entities should be required to use the fair value of the equity instruments granted as a surrogate measure of the fair value of the services received. The Board also noted that with respect to goods received, the fair value of those goods would be used to measure the transaction.
- the Board discussed a minor drafting point concerning the ED’s provisions on when a liability exists in situations in which an entity may settle its obligations under a share or option grant in cash rather than by issuing equity instruments.

The Board also discussed the draft disclosures in the ED, which the staff had prepared on the basis of earlier Board decisions and other relevant accounting standards. The Board tentatively agreed to include the draft disclosures in the ED, along with illustrative examples. The Board noted that before the IFRS is finalised, it would reconsider the required disclosure along with other proposals in the ED in the light of comments received from respondents to the ED.

The Board agreed that the length of the comment period for the exposure draft, to be published later this year, should be 120 days.

Meeting dates: October – December 2002

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

23 – 29 October‡

12 – 16 November, Hong Kong SAR, China†

18 – 20 December

† Includes a meeting with the Standards Advisory Council

‡ Includes a meeting with partner national standard-setters