

The International Accounting Standards Board met in London on 17–19 December 2003, when it discussed:

- Business combinations
- Consolidation and SPEs
- Disposal of non-current assets and presentation of discontinued operations
- Exploration for and evaluation of mineral resources
- Financial instruments – hedging
- IFRIC issues
- Insurance contracts
- Intangible assets and IFRS 1
- Post-employee benefits
- Revenue recognition
- Share-based payment
- Financial reporting by small and medium-sized entities

Business Combinations (phase I)

Business combinations involving two or more mutual entities and business combinations in which separate entities or businesses are brought together to form a reporting entity by contract

The Board considered an issue that arose during the drafting of the pre-ballot version of the IFRS on business combinations. The issue related to the Board's previous decision to delay the application of the IFRS to the accounting for the following transactions until it issued guidance on the application of the purchase method to them:

- business combinations involving two or more mutual entities; and
- business combinations in which separate entities or businesses are brought together to form a reporting entity by contract only without the obtaining of an ownership interest (for example, combinations in which separate entities are brought together by contract, ie without the passing of consideration, to form a dual-headed/listed corporation).

The Board's reason for adopting this approach was explained in paragraph BC146 of the Basis for Conclusions on ED 3:

"The Board observed that differences between the ownership structures of mutual entities (such as mutual insurance companies or mutual cooperative entities) and those of investor-owned entities mean that some complications arise in applying the purchase method to business combinations involving two or more mutual entities. Similarly, the Board has noted that complications arise in applying the purchase method to combinations involving the formation of a reporting entity by contract only without the obtaining of an ownership interest. The Board is considering issues associated with the application of the purchase method to these transactions as part of the second phase of its Business Combinations project. Therefore, until those issues are resolved, the accounting for such transactions will continue to be dealt with by IAS 22."

At this meeting the Board observed that continuing to apply IAS 22 *Business Combinations* to such transactions would result in them being classified either as unitings of interests or acquisitions. If such a transaction were to be classified as a uniting of interests, it would be required under IAS 22 to be accounted for by applying the pooling of interests method. The Board agreed that this would not be consistent with its conclusion that the pooling of interests method does not provide information superior to that provided by the purchase method in any circumstances. The Board also observed that if such a transaction were classified as an acquisition, IAS 22 would require it to be accounted for by applying the purchase method, but a version of the purchase method different from that contained in the IFRS.

The Board was concerned that two versions of the purchase method would co-exist for a period of time until the Board was able to issue guidance on the

application of the purchase method to business combinations involving two or more mutual entities and business combinations in which separate entities or businesses are brought together to form a reporting entity by contract only.

The Board discussed whether the IFRS should be applied to such business combinations, focusing on two issues that might arise in applying the purchase method to them. First was the suggestion that it might be difficult to identify the acquirer in such business combinations. However, the Board reaffirmed the conclusion it reached in developing ED 3, which was outlined in paragraphs BC34-BC35 of the Basis for Conclusions on ED 3:

"BC34 The Board observed that in some business combinations, domestic legal, taxation or economic factors can work to make it extremely difficult to identify an acquirer. This can occur, for example, when entities of similar sizes or capitalisations come together through industry restructurings, with existing managements and staffing retained and integrated. The Board considered detailed arguments as to whether such factors could make it impossible to identify an acquirer in a business combination and, if so, whether the pooling of interests method should be permitted in such circumstances. The Board

(continued...)

**Copyright © IASB Update is published immediately after every IASB meeting by the International Accounting Standards Board,
30 Cannon Street,
London EC4M 6XH, United Kingdom
Email: iasb@iasb.org.uk
Website: www.iasb.org**

**IASB Publications Department,
30 Cannon Street, London, EC4M 6XH
United Kingdom
Tel: +44 (0)20 7332 2730
Fax: +44 (0)20 7332 2749
Email: publications@iasb.org.uk
ISSN 1474-2675**

Business combinations (phase I) (*continued*)

also considered whether applying the purchase method to combinations for which identifying the acquirer is difficult could result in an arbitrary selection of an acquirer and therefore be detrimental to the comparability of accounting information. As part of its deliberations, the Board considered case studies that related to actual situations encountered in practice.

BC35 Whilst acknowledging that it could be very difficult to identify an acquirer in some circumstances, the Board did not agree that exceptions to applying the purchase method should be permitted. The Board concluded that the pooling of interests method does not provide superior information to that provided by the purchase method in any circumstance, even if identifying the acquirer is problematic.”

The second issue was the concern that combinations between mutual entities and combinations in which separate entities or businesses are brought together to form a reporting entity solely by contract normally do not involve the payment of readily measurable consideration. Therefore, difficulties would arise in estimating the cost of the business combination and any goodwill acquired in the combination. The Board agreed that until it develops as part of phase II of its Business Combinations project guidance on applying the purchase method to such transactions, the IFRS should include such transactions within its scope, but require the aggregate fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities to be treated as the deemed cost of the business combinations. Therefore, no goodwill would arise in the accounting for such combinations.

However, the Board concluded that it would not be appropriate to incorporate this decision into the phase I IFRS on Business Combinations without first exposing the decision for public comment. Therefore, the Board decided:

- to proceed with issuing the phase I IFRS on Business Combinations before the end of March 2004, and to exclude from the scope of that IFRS business combinations between mutual entities and combinations in which separate entities or businesses are brought together to form a reporting entity by contract only.
- To publish as soon as possible an exposure draft proposing a limited amendment to the IFRS whereby such combinations would be included within the scope of the IFRS, but with the aggregate fair value of the acquiree’s identifiable assets, liabilities and contingent liabilities being treated as the deemed cost of the combination. The amendment would have a similar effective date as the IFRS.

Consolidation and SPEs

In September, the Board agreed that when an entity (the investor):

- (a) has the power to determine the strategic operating and financing policies of another entity (the power criterion);
- (b) has the ability to benefit (the benefit criterion); and
- (c) is able to use that power so as to increase, protect or limit the risk of downside in that benefit

the investor has control of that other entity and should consolidate it. The September discussion addressed control of entities generally, without considering special purpose entities

(SPEs) in particular. At this meeting the Board discussed whether the concept of control could be applied to all entities by considering SPEs as defined below. The Board did not discuss the recommended approach to the consolidation of SPEs.

For the purposes of the discussion only and not necessarily for any future publication, SPEs were defined to include only a subset of those entities commonly considered to be SPEs. In particular, in order to test the control notion agreed in September, the discussion focused on those entities to which the power criterion may not be applicable. Therefore, SPEs were defined as entities whose policies were so extensively predetermined, that the remaining policies cannot be described as that entity’s ‘strategic operating and financing policies’. The Board noted that, in effect, the entities requiring separate consideration are those whose outstanding policy determination is established to a degree that precludes any action that would alter the entity’s performance.

The Board considered whether the power criterion was applicable to SPEs as defined. The Board agreed that the entity responsible for predetermining an SPE’s strategic operating and financing policies satisfies the power criterion. Such an entity is likely to be that SPE’s controller. However, an entity involved with an SPE post-policy determination seems unable to satisfy the power criterion. However, the Board noted that an entity ultimately responsible for an SPE’s policy determination might use an agent and that an entity that appears to be involved only with an SPE post-policy determination might have directed policy determination. These entities would satisfy the power criterion. The Board noted that indicators, such as an entity’s risk exposure to an SPE and whether the SPE’s activities further an entity’s business purposes, might assist in identifying the entity ultimately responsible for an SPE’s predetermined policies.

At the September meeting the Board agreed that a principal objective of consolidation is to recognise assets controlled by an entity. Thus the Board considered whether an entity involved with an SPE post-policy determination can control that SPE’s assets.

The staff noted that parties exposed to an entity’s residual risks usually require control of that entity to protect their risk position. Therefore, an association between an entity having a risk exposure to another entity and its controlling that entity is likely. However, the staff does not believe this means that residual risks and rewards equate to control. The staff also observed that investors exposed to fluctuations in an SPE’s performance, unlike investors exposed to fluctuations in a non-SPE’s performance, do not have the same motivation to control an SPE if they choose to rely on its predetermined strategic operating and financing policy.

The staff also observed that usually only an entity able to determine how assets are employed and how related future economic benefits are deployed, so as to benefit, controls those assets. Participants in an SPE who obtain their interests after the SPE’s policies have been determined, although able to control their interests in the SPE, are unable to determine how an SPE’s assets are employed or how the future economic benefits on the SPE’s assets are deployed. Therefore, they seem unable to control an SPE’s assets.

The Board noted the staff’s view but asked that further consideration be given to an SPE’s liabilities. In particular, the Board asked the staff to investigate the circumstances when an

entity involved with an SPE post-policy determination might be responsible for an SPE's liabilities so that recognition of those liabilities through consolidation would be appropriate.

The Board asked the staff to test the effectiveness of identifying controllers of SPEs by finding those ultimately responsible for predetermining an SPE's policies by applying this approach to common structures. The staff also undertook to provide the Board with more information on the types of transactions that would be likely to involve SPEs as defined.

Disposal of non-current assets and presentation of discontinued operations

Analysis of comments received on ED 4

The Board considered the following general issues:

- The timing of any requirements arising from ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations*
- Convergence with the requirements in FAS 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*
- Whether the IASB should issue a new IFRS or amend existing standards.

The Board also discussed an analysis of comments received in response to questions 1-4 in the Invitation to Comment on the ED.

General issues

Timing

Some respondents suggested that the proposals in ED 4 should be deferred until the Board – in light of its pressing agenda between now and March 2004 – had more time to consider the standard. They also argued that the existing requirements of IASs were not causing substantial problems in practice and the benefits of convergence in the short term did not seem to be substantial. The Board noted, however, that the proposals in ED 4 are important to users and should not be regarded as having lower priority than other projects. The Board also noted that for the sake of convergence the project should not be deferred.

Convergence with FAS 144

Many respondents noted that the requirements of ED 4 seemed prescriptive and rules-based and were not consistent with a principles-based approach or other IASs. The Board acknowledged the comments but noted that many respondents also agreed with the proposal to converge with the requirements in FAS 144 for assets held for sale and discontinued operations. The Board noted that it has agreed with the FASB to undertake a convergence project, and that convergence with US GAAP is the principal objective of ED 4. However, the Board agreed that it would consider separately each issue raised.

New IFRS or amend existing standards

The Board discussed whether it would be preferable not to issue a new IFRS but to amend existing standards. The Board agreed that it would be easier for users of IFRSs to have all the requirements for assets held for sale and discontinued operations in one standard. If, later in the process, the Board decided to move closer to the requirements of existing standards, it would reconsider the matter.

Classification of non-current assets held for sale

ED 4 proposed that non-current assets should be classified as assets held for sale if specified criteria are met. Several respondents disagreed with the classification. They objected primarily for the following, different reasons:

- the proposed criteria are too rules-based and restrictive
- an entity should demonstrate a commitment to sell before classifying an asset as held for sale
- the separate classification should apply to 'assets retired from active use'
- assets to be abandoned should be included in the category of assets held for sale
- an exchange of assets should not be regarded as a sale transaction.

The Board discussed whether the classification should be more principles-based. The Board confirmed the criteria and noted that a more flexible definition would be open to potential abuse. Also, changing the proposed classification would diverge from, rather than converge, with US GAAP. However, the Board agreed to modify the wording and highlight the principles for classifying assets as held for sale.

Some respondents argued that an entity should demonstrate a commitment to sell before an asset should be classified as held for sale. This would be consistent with the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* relating to restructuring provisions. The Board observed that the requirements of IAS 37 establish when a liability is incurred, whereas the proposals under ED 4 relate to the classification and measurement of assets that already exist. Hence, in the Board's view, it is not necessary that the classification under ED 4 be consistent with the requirements of IAS 37. The Board also noted that, at a later stage in the convergence project, it would consider amending IAS 37 and converge with FAS 146 *Accounting for Costs Associated with Exit or Disposal Activities*. This would likely postpone the timing of the recognition of restructuring provisions.

The Board considered whether the separate classification should apply to assets retired from active use, rather than assets held for sale, and whether assets to be abandoned should be included in the separate presentation. The Board reconfirmed its proposal but agreed to further clarify its reasoning in the Basis for Conclusions.

The Board also reconfirmed its proposal that exchanges of assets should be considered as sale transactions. However, the Board noted that under IAS 16 *Property, Plant and Equipment* (2003), only exchange transactions with commercial substance are recognised at fair value. The Board decided to clarify that this applies to exchange transactions under ED 4 as well.

Measurement of non-current assets classified as held for sale

ED 4 proposed that non-current assets classified as held for sale should be measured at the lower of carrying amount and fair value less costs to sell. Several respondents disagreed with the proposal, arguing that:

- a classification of assets as held for sale should not trigger a change in measurement basis
- depreciation should not cease while the assets are still in active use
- the proposal would require an impairment loss to be recognised too early
- the measurement basis is inconsistent with other Standards.

The Board noted the respondents' arguments. However, the Board decided to retain the proposed measurement basis. The Board noted that a change in measurement basis is justified because an asset is classified as held for sale only if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. Moreover, in the Board's view, the proposal would not result in significant differences between the recognised amount and what would be recognised

under requirements in existing Standards, including IAS 16, IAS 36 and IAS 38. The Board agreed to further clarify this matter in the Basis for Conclusions.

Disposal groups

ED 4 proposed that assets and liabilities that are to be disposed of together in a single transaction should be treated as a disposal group. The measurement basis proposed for non-current assets classified as held for sale should be applied to the group as a whole and any resulting impairment loss would reduce the carrying amount of the non-current assets in the disposal group.

The Board first noted that the relationship between disposal groups and cash-generating units is not clear and should be clarified in the final IFRS. The Board also agreed to clarify the interaction between the scope of ED 4 and the application of the requirements to disposal groups.

The Board then discussed the proposed allocation of an impairment loss. Some respondents pointed out that there is a mismatch between the measurement of assets and the measurement of liabilities in the disposal group, which may affect the allocation. The Board agreed with this view but noted that different measurement bases in other standards caused this, and that a solution of this matter was beyond ED 4. Other respondents had argued that the allocation in ED 4 should be consistent with the allocation of an impairment loss in accordance with IAS 36 *Impairment of Assets*. The Board observed that this would diverge from US GAAP. However, the Board noted that a different allocation would not create a reconciling item because the total carrying amount of the disposal group would not be affected. Therefore, the Board agreed to amend its proposal, so that, consistently with IAS 36:

- an impairment of any goodwill allocated to a disposal group should not be calculated separately but that the allocation of the impairment loss of the disposal group as a whole should be allocated first to goodwill, and
- the allocation of any remaining impairment loss should be allocated pro rata to all the assets in the disposal group.

Newly acquired assets

ED 4 proposed that newly acquired assets that meet the criteria to be classified as held for sale should be measured at fair value less costs to sell on initial recognition. Therefore, it proposed a consequential amendment to the draft IFRS *Business Combinations* so that non-current assets acquired as part of a business combination that meet the criteria to be classified as held for sale would be measured at fair value less costs to sell on initial recognition, rather than at fair value as required at present.

The Board reconfirmed its proposal, except for situations in which the consideration paid for a newly acquired asset classified as held for sale is less than the fair value of that asset. For example, if such consideration is less than fair value, the proposed initial measurement at fair value less costs to sell may result in the recognition of a gain (if the asset is not acquired as part of a business combination). Therefore the Board agreed to amend paragraph 9 of ED 4 as follows: “If a newly acquired asset (or disposal group) meets the criteria for held for sale (see paragraph B3 of Appendix B), it shall be measured on initial recognition at the lower of cost and fair value less costs to sell. However, if the asset (or disposal group) acquired is part of a business combination, it shall be measured on initial recognition at fair value less costs to sell.”

Exploration for and evaluation of mineral resources

The Board considered whether the guidance on the initial and subsequent measurement of exploration and evaluation assets proposed in ED 6 *Exploration for and Evaluation of Mineral Resources* (due to be released in January 2004) appropriately reflects what the Board intended.

When drafting ED 6, the staff had thought that the guidance was incomplete because it addressed only those expenditures that could be included in the exploration and evaluation asset and did not address those expenditures that could not be included. The proposed guidance was based on equivalent paragraphs in IAS 16.

A concern was raised that the requirement to recognise an asset initially at cost might be a change in practice – for example, an entity might include some estimate of the value of reserves in the initial carrying amount of the exploration and evaluation asset recognised. In addition, some of the items prohibited in the proposed guidance might be included. Finally, the requirement to apply either IAS 16 or IAS 38 might cause changes to existing practices.

The Board confirmed that the proposed guidance proposed should be included in ED 6.

Fair value hedge accounting for a portfolio hedge of interest rate risk

In August, the Board published an Exposure Draft *Fair Value Hedge Accounting for Portfolio Hedge of Interest Rate Risk* (commonly referred to as ‘macro hedging’). It invited comments by 14 November. Over 120 comment letters have been received.

The Board considered:

- a summary of the key points made in the comment letters on the two questions asked in the exposure draft.
- a summary of the main issues raised by respondents on which no question was asked.
- a proposed project plan.

The Board was not asked to make any technical decisions at this meeting, pending a more detailed analysis of the issues. However, the staff asked for direction as to which of the other issues raised by respondents should be considered in finalising the proposals. The Board tentatively agreed to address the following other such issues:

- Amortisation of balance sheet amounts, ie when and how to amortise any amounts reported in the balance sheet for changes in the fair value of the hedged item.
- How to apply IAS 39’s effectiveness requirements (ie the “almost fully offset” test and the “80-125 per cent” test) to a macro hedge.
- Transitional provisions, both for those entities already using IAS 39 and for those adopting IAS 39 for the first time.

The Board tentatively agreed not to consider further whether to extend the proposals in the exposure draft to portfolio hedges of other risks (eg foreign currency risk, commodity price risk, or credit risk). The Board confirmed the reasons for limiting its proposals to portfolio hedges of interest rate risk as set out in paragraph BC4 of the exposure draft. It also tentatively agreed not to revisit IAS 39’s requirement to eliminate, in consolidated financial statements, the effects of internal contracts used in treasury centre hedges of foreign currency risk.

IFRIC issues

The Board discussed the IFRIC's agenda item *Emission Rights* in the light of the IFRIC's recent redeliberations of the comments received on its draft Interpretation.

Limited amendment to IAS 38

The Board was informed that the IFRIC had considered the alternative accounting models for emission right schemes proposed by respondents to the draft Interpretation, but had concluded that its draft Interpretation was the most appropriate interpretation of current IFRSs. The Board was also informed that the IFRIC had concluded that the most appropriate accounting treatment for emission allowances traded in an active market is to measure those allowances initially and subsequently at fair value with all changes in value recognised in profit or loss, a treatment not currently permitted by IAS 38 *Intangible Assets*.

The Board was informed that the IFRIC had concluded that emission allowances are like a currency and therefore can be distinguished from other intangible assets referred to in IAS 38. This is because an emission allowance has value only because it is used to settle an obligation (ie the obligation to deliver allowance as a result of past emissions).

Therefore the Board agreed to the proposal from the IFRIC to issue an exposure draft to propose a limited amendment to IAS 38 so that any intangible asset

- that is like a currency, in that it has value only because it is used to settle an obligation; and
- whose fair value is determinable by reference to an active market (as defined in IAS 38)

is measured at fair value with changes in value recognised in profit or loss. As indicated below, this would require exposure.

IAS 20

The Board noted that an important reference for the IFRIC's draft Interpretation is IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. This is because the IFRIC has proposed that when allowances are allocated by government to an entity for less than fair value, the difference between their fair value and the amount paid is a government grant, which is accounted for in accordance with IAS 20.

The Board has previously tentatively agreed to withdraw IAS 20 and to replace it with a new IFRS that is consistent with the *Framework*. In the light of the IFRIC's work on emission rights, and also as a result of concerns with IAS 20 expressed by some of the Board's partner standard-setters, the Board directed the staff to accelerate work on the project to replace IAS 20. In particular, the Board asked the staff to consider whether IAS 20 could be replaced by extending the requirements for government grants at present contained in IAS 41 *Agriculture*. The Board is expected to consider this issue early in 2004.

The Board also asked the staff to consider the implications of withdrawing IAS 20 and prohibiting the recognition of deferred credits. For example, in the case of an emission rights scheme, the Board questioned whether there might be a service obligation associated with the allocation of emission allowances (ie the grant) that might meet the definition of a liability.

Finally, the Board decided that, should it proceed to withdraw IAS 20, the IFRIC should re-expose its Interpretation at the same time that the Board exposes the proposal to withdraw IAS 20, so that the new draft Interpretation could reflect the proposed withdrawal of IAS 20 as well as the proposed amendment to IAS 38.

Two Board members disagreed with the proposal because it eliminated the existing option in IAS 38 to measure emission allowances that are traded in an active market at cost.

Insurance Contracts (phase I)

The Board continued its discussion of the comment letters received on ED 5 *Insurance Contracts*, with specific reference to:

- assets backing insurance contracts
- shadow accounting
- temporary exemption from the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- changes in accounting policies
- scope
- weather derivatives
- definition of an insurance contract
- embedded derivatives
- unbundling of deposit components

Assets backing insurance contracts

Many respondents asked the Board to address possible inconsistencies between the measurement of an insurer's assets and the measurement of its liabilities (described by some as a 'mismatch'). The proposals in ED 5 would not create this 'mismatch'; it already exists in IFRSs. Continuing its discussion from November, the Board discussed the following three approaches:

- to relax the criteria in IAS 39 *Financial Instruments: Recognition and Measurement* for classifying a fixed-maturity asset as held-to-maturity and the related 'tainting provisions.'
- to create a new category of fixed-maturity assets that could be measured at amortised cost if they meet various restrictions to be determined.
- to adjust the measurement of specified interest-sensitive insurance liabilities to reflect changes in interest rates.

Board members indicated that:

- some are uncertain whether there is a need for any of these approaches.
- if any approach is required, the third approach is conceptually more appropriate than the first two approaches. However, it may be more difficult to implement.
- if the Board adopts either of the first two approaches, IAS 32 *Financial Instruments: Disclosure and Presentation* would require disclosure of the fair value of the assets carried at amortised cost.

The staff and some Board members will meet representatives of European insurers in January to discuss this topic further. The Board expects to make a final decision at its January meeting.

Shadow accounting

The Board decided that:

- an insurer may (but is not required to) change its accounting policies so that a recognised but unrealised gain or loss on an asset affects the measurement of related insurance liabilities (and deferred acquisition costs) in the same way that a realised gain or loss does. If the unrealised gains or losses are recognised directly in equity, the related adjustment to the insurance liability or deferred acquisition costs is also recognised in equity. This practice is sometimes described as 'shadow accounting'.

- the Basis for Conclusions should clarify that shadow accounting is not the same as fair value hedge accounting under IAS 39 and will not usually have the same effect.
- Shadow accounting is not relevant for liabilities arising under investment contracts (ie contracts subject to IAS 39) because the underlying measurement of those liabilities does not depend on asset values or asset returns, unless those contracts contain a discretionary participation feature.

Temporary exemption from the hierarchy in IAS 8

IAS 8 specifies a hierarchy of criteria for an entity to use in developing an accounting policy for an item if no IFRS applies specifically to that item. The Board:

- re-affirmed the proposal in ED 5 to exempt an insurer from applying those criteria to most aspects of its existing accounting policies for insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds, and
- decided to delete the ‘sunset clause’ proposal in ED 5 that would have made this exemption expire in 2007.

Changes in accounting policies

The Board re-affirmed the proposal in ED 5 that changes in accounting policy for insurance contracts would be permitted if they make the financial statements reliable and more relevant.

ED 5 proposed an absolute prohibition on changes in accounting policies if the change introduces measurements that reflect future investment margins. The Board decided to replace this with a rebuttable presumption that an insurer’s financial statements will become less relevant and reliable if it introduces such measurements.

The Board concluded that an insurer might overcome that rebuttable presumption if the other components of the change in accounting policies increase the relevance and reliability of its financial statements sufficiently to outweigh the inclusion of future investment margins. For example, an insurer’s existing accounting policies for insurance contracts might involve excessively prudent assumptions set at inception and a discount rate prescribed by a regulator without direct reference to market conditions. The insurer might make its financial statements more relevant and reliable by switching to a comprehensive basis of accounting that is widely understood by investors and involves:

- updated current best estimate assumptions
- a reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty, and
- a current market discount rate, even if that discount rate reflects the expected return on the insurer’s assets.

In some measurement approaches, the discount rate is used to determine the present value of a future profit margin. That profit margin is then attributed to different periods in proportion to a profit driver determined by the insurer’s accounting policies. In those approaches, the discount rate affects the measurement of the liability only indirectly. In particular, the use of a less appropriate discount rate has a limited or no effect on the measurement of the liability at inception. In other approaches, the discount rate determines the measurement of the liability directly. In the latter case, because the introduction of an asset-based discount rate has a more significant effect, it is harder to overcome the rebuttable presumption described above.

The Board also decided that:

- the introduction of the other practices listed in paragraph 16 of ED 5 would not be permitted as changes in accounting principle.

- as proposed in ED 5, when an insurer changes its accounting policies for insurance liabilities, it would be permitted, but not required, to reclassify some or all financial assets as at fair value through profit or loss. The Board will consider in January whether reclassification should also be permitted into the category of available-for-sale financial assets.

Scope

The Board decided to retain the scope exclusions proposed in ED 5. The Board also agreed to include an example in the Implementation Guidance to clarify the treatment of an insurance contract issued to employees on the same terms as to third parties. Among other things, ‘on the same terms’ means that the benefits relating to employee service in the current and prior periods cannot be contingent on future service. This contract will be subject to the phase I standard. If the employer pays part or all of the employee’s premiums, the payment by the employer is an employee benefit subject to IAS 19 (see also IAS 19 *Employee Benefits*, paragraphs 39-42, 104 and 104A-D). Furthermore, a ‘qualifying insurance policy’ as defined in IAS 19 need not meet the definition of an insurance contract (ie a financial instrument subject to IAS 39 could be a ‘qualifying insurance policy’).

Some respondents suggested that the scope of this IFRS should exclude some prepaid contracts to provide services, such as:

- fixed fee service contracts when the level of service depends on an uncertain event, for example maintenance contracts when the service provider agrees to repair specified equipment after a malfunction. The fixed service fee is based on the expected number of malfunctions, although it is uncertain whether the machines will break down. The malfunction of the equipment adversely affects its owner and the contract compensates the owner (in kind, rather than in cash).
- car breakdown services if each callout has little incremental cost because the bulk of breakdown assistance is provided through employed patrols, the motorist pays separately for parts (eg batteries), the need to provide assistance (and the related cost) is known within hours, the number of callouts is limited and the services are not regulated by insurance supervisors.

The Board concluded that such contracts meet the definition of an insurance contract and should not be excluded from the scope of the phase I standard. However, applying the phase I standard is not likely to be onerous for such contracts as it does not require changes to existing accounting policies for such contracts. The Board may revisit the treatment of these contracts if the outcome of phase II differs significantly from the outcome of the project on Revenue Recognition.

Weather derivatives

ED 5 distinguishes an insurance contract from other instruments, such as derivatives. Therefore, ED 5 proposed that weather derivatives should be within the scope of IAS 39 unless they meet the proposed definition of an insurance contract. The Board confirmed this proposal.

The Board noted that this conclusion is also relevant for catastrophe bonds. In substance, these bonds contain embedded weather derivatives or embedded insurance contracts. It follows that the treatment of catastrophe bonds depends on whether they include a condition that the issuer suffered a loss.

The Board re-affirmed the proposal to amend the definition of a derivative by extending the phrase ‘other variable’ so that it reads ‘other variable, provided in the case of a non-financial

variable that the variable is not specific to a party to the contract’.

Definition of an insurance contract

The Board decided to retain the definition proposed in ED 5. The Board noted that the notion of insurable interest is expressed in several places: three references in the definition of an insurance contract (acceptance of risk from the policyholder, compensate the policyholder or other beneficiary, adverse effect) and also in the definition of financial risk (non-financial variable not specific to a party to the contract). The Board decided not to eliminate this possible redundancy.

Pure endowment

Many respondents read IG Example 1.4 as implying that pure endowments do not generally transfer insurance risk. The Board decided to redraft IG Example 1.4 to clarify that they are insurance contracts unless the risk transfer is insignificant and explain that an insurer need not examine each contract in a portfolio of pure endowments to identify which ones transfer significant insurance risk.

Significance of insurance risk

The Board decided to:

- keep ‘significant insurance risk’ as the test for whether a contract transfers sufficient insurance risk to qualify as an insurance contract.
- amend paragraphs B21-B24 of Appendix B of ED 5 by replacing the notion of plausible scenarios with an instruction to ignore scenarios that have no commercial substance, and deleting the term ‘trivial’ to use only the terms ‘significant’ and ‘insignificant’.

Some respondents asked for clarification of the meaning of paragraphs B21-B24, particularly the phrase ‘net cash flows arising from the contract’. The Board discussed the example of a unit-linked contract that pays 100% of unit value on surrender or maturity and 101% of unit value on death. Assume that the issuer expects a profit of 5% over the life of the contract, on average. The profit comes from investment management fees (less related expenses) over the life of the contract, less mortality payments.

The Board reaffirmed that this contract could be unbundled into an insurance component and a deposit component (and should be unbundled if the insurance component is regarded as material). If it is not unbundled, the insurance risk in the entire contract is insignificant.

Surrender charges

Some respondents suggested that IG Example 1.2, where the death benefit exceeds the surrender amount, would cover almost any contract that has a redemption penalty that is waived on death. The Board noted that many of these contracts would not meet the definition of an insurance contract because the issuer does not accept a pre-existing risk from the counterparty.

Embedded derivatives

IAS 39 requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss.

Definition of an embedded derivative

The Board discussed examples that some respondents did not regard as embedded derivatives. For example, some referred to an option to take a life-contingent annuity at a guaranteed rate. They argued that the price of this option would not depend on a specified variable, or underlying, but rather on interest rates generally.

The Board concluded that this item (and the others discussed) is an embedded derivative. Although the variable itself is not, in

some cases, named explicitly in the contract, in each case, the contract specifies a rate or amount that includes an implicit or explicit reference to a particular level of a variable (such as interest rates).

Summary of changes for embedded derivatives

The Board decided to make the following changes to the proposals in ED 5:

- There should be an explicit new exemption from the requirement to separate, and measure at fair value, options to surrender a contract with a discretionary participation feature.
- Unit-denominated payments could be measured at current unit values, for both insurance contracts and investment contracts, and that this would avoid the apparent need to separate an ‘embedded derivative.’
- If an embedded derivative produces a pay-off only when its host insurance contract matures and a zero pay-off on earlier surrender or death, the embedded derivative is a pure endowment, and hence an insurance contract, unless the insurance risk is insignificant.
- If an insurer is required, or elects, to unbundle an insurance contract into a deposit component and an insurance component, it may not be possible to measure the option to cancel the deposit component without considering the related option to cancel the insurance component. If so, the entire surrender option should be treated as part of the insurance component.

The Board re-affirmed the following proposals in ED 5:

- Some embedded derivatives transfer significant insurance risk but many regard them as predominantly financial (such as the guaranteed life-contingent annuity options and guaranteed minimum death benefits described in paragraph BC123 of the Basis for Conclusions). These items need not be measured at fair value because they meet the definition of an insurance contract.
- If the surrender value of an investment contract can differ significantly from its carrying amount, there is no exemption from the requirement to separate the surrender option and measure it at fair value.
- There should be no exemption from the requirement to separate and measure at fair value options to surrender a life insurance contract for a value determined by the retrospective value of the insurance contract, ie the premium with the addition of any bonus (eg interest) and deduction of costs, risk premiums and a surrender charge.
- Under IAS 39, embedded interest floors and caps are treated as (a) closely related if issued out of the money and (b) not closely related if issued in the money. Some respondents on ED 5 viewed this distinction as arbitrary. However, the Board concluded that it is beyond the scope of this project to address these concerns.

The Board will reconsider the following topics in January:

- Whether the cash flows considered in a loss recognition test should include the effect of embedded guarantees and options. However, the Board decided that the inclusion of these cash flows in a loss recognition test would not justify an exemption from measuring embedded derivatives at fair value under IAS 39.
- Whether embedded derivatives that are interdependent with the host insurance contract are closely related to the host contract and, hence, exempt from separate measurement at fair value.

Unbundling of deposit components

ED 5 proposed that unbundling should be required in limited cases. The Board reaffirmed that unbundling should be:

- permitted if the deposit component (including any embedded surrender options) can be measured without considering the insurance component.
- required if some rights and obligations under the deposit component would otherwise remain unrecognised (and the condition in the previous point is satisfied).

The Board concluded that the first criterion should still be one-sided (ie can measure the deposit component without considering the insurance component) rather than two-sided, as proposed by some commentators. For example, in some life insurance contracts, the death benefit is the difference between (a) a fixed amount and (b) the value of a deposit component (for example, a unit-linked investment). The deposit component can be measured without considering the insurance component, but the death benefit depends on the unit value so it cannot be measured without considering the deposit component. In general it is likely that all the rights and obligations under the deposit component would be recognised, so that unbundling is not required. If this condition is not met, unbundling would be appropriate.

Application and Implementation Guidance

The observer notes for this meeting include staff recommendations for amendments to the Application and Implementation Guidance on the definition of an insurance contract, embedded derivatives and unbundling. The observer notes are available on the IASB's web site www.iasb.org. They were prepared before the decisions taken at this meeting, and are subject to further change.

Next steps

The Board expects to discuss the following issues in January:

- Further discussion on assets backing insurance contracts
- Non-financial assets (such as investment property and owner-occupied property) held to back insurance contracts
- Deposit floor for investment contracts. *Deposit floor* is an informal name for the constraint that the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid
- Scope – financial guarantees and credit insurance
- Investment contracts (carried forward from December)
- Embedded derivatives (see above for details)
- Discretionary participation features (carried forward from December)
- Disclosure
- Transition and effective date.

The Board plans to publish a final IFRS by the end of March 2004.

Intangible assets and IFRS 1 *First-Time Adoption of IFRSs*

The Board considered an agenda paper prepared by the Australian Accounting Standards Board (AASB) staff on the transitional arrangements in IFRS 1 for intangible assets. IFRS 1 requires a first-time adopter to apply IAS 38 *Intangible Assets* retrospectively. This involves the derecognition of:

- all intangible assets that do not meet the recognition criteria in IAS 38 at the date of transition to IFRSs. Therefore, some internally generated intangible assets, such as brands

and customer lists, must be derecognised upon transition to IFRSs.

- revaluations of intangible assets that do not meet the criteria for revaluation in IAS 38.

Existing Australian GAAP applies the general asset definition and recognition criteria in the Australian *Conceptual Framework* for the recognition of intangible assets. Therefore, entities are permitted to recognise an intangible item as an intangible asset when that item satisfies both the definition of an asset and the general asset recognition criteria. These criteria apply irrespective of the derivation of the intangible item. Therefore, Australian entities are able to recognise intangible assets that cannot be recognised under IAS 38. Additionally, all recognised intangible assets can be measured under Australian GAAP at cost or revalued amount. Revaluations must be at fair value.

The AASB staff stated that the derecognition of affected internally generated intangible assets and past fair value revaluations on transition to IFRSs would result in less useful information being provided to users of financial statements, and ultimately compromise the comparability of Australian financial statements. The AASB staff also suggested that comparability would be further compromised by paragraph 19 of IFRS 1, because that paragraph permits a first-time adopter to use an event-driven fair value measurement of an asset, including an intangible asset, as the asset's deemed cost for IFRSs. This means that some entities, such as those that have recognised revaluations in conjunction with first, second or third public offerings or share buybacks, will not be required to derecognise past fair value revaluations on transition to IFRSs.

However, the Board disagreed that the transitional arrangements for intangible assets in IFRS 1 would compromise the comparability of financial statements, noting that:

- Australian entities, although not precluded under Australian GAAP from recognising internally generated intangible assets that meet the general asset definition and recognition criteria, are nonetheless not required under Australian GAAP to recognise such assets in the absence of a transaction.
- Australian entities are given the option, but are not required, under Australian GAAP to revalue intangible assets to fair value.
- the Board's intention in including paragraph 19 in IFRS 1 was to deal with circumstances in which a first-time adopter has, because of a significant event such as a privatisation or initial public offering, established the fair values of some or all of its assets on a particular date as their deemed cost under previous GAAP, because reconstruction of a cost that complied with previous GAAP would have involved undue cost and effort.

The Board reaffirmed its earlier conclusion when developing IFRS 1 that requiring all first-time adopters to apply IAS 38 retrospectively will improve the comparability of financial reporting at an international level. Therefore, the Board unanimously agreed not to amend IFRS 1 at this time.

However, Board members remained concerned that paragraph 19 of IFRS 1 might be open to interpretation in a manner other than that intended. The Board agreed to refer this matter to the IFRIC to develop possible amendments to IFRS 1 for the Board's consideration.

Post-employment benefits

The Board considered how to proceed with its work on post-employment benefits given its decision at the November meeting not to amend IAS 1 *Presentation of Financial Statements* to achieve a particular outcome for the recognition of actuarial gains and losses.

The Board agreed that a proposal for a comprehensive project on post-employment benefits covering all areas should be developed for consideration by the joint agenda working party with the FASB.

The Board also agreed in the short term to develop an exposure draft proposing to add an option to IAS 19 *Employee Benefits*. An entity choosing to recognise actuarial gains and losses in full in the period in which they occur would be permitted to recognise them outside profit or loss in a statement of recognised income and expenses as described in paragraph 96 of IAS 1. Entities choosing this option would have to apply it to all actuarial gains and losses as currently defined under IAS 19 and to all defined benefit plans. The actuarial gains and losses would not be recycled into profit or loss in a subsequent period. The Basis of Conclusions on the exposure draft would make it clear that the Board does not believe that the recognition of actuarial gains and losses outside profit or loss is the ideal solution. Rather it is an interim step pending resolution of the project on reporting comprehensive income. The Board is proposing the addition of this option to IAS 19 in the meantime to help those jurisdictions that already allow the immediate recognition of actuarial gains and losses outside profit or loss or are reluctant to adopt the deferred recognition approaches in IAS 19.

The Board also agreed to propose to amend IAS 19 so that individual companies in a consolidated group that participate in a defined benefit plan that covers the group can apply defined contribution accounting in their separate financial statements.

The Board agreed to propose the disclosure of the major classes of assets held by a defined benefit plan and the expected rate of return for each class of asset. It also agreed to propose the disclosure of five-year histories of:

- the present value of the plan liabilities, the fair value of the plan assets and the surplus/deficit in the plan and
- the experience gains/losses arising on the plan liabilities and the plan assets expressed as (i) an amount and (ii) as a percentage of the plan liabilities at the balance sheet date.

Finally, the Board agreed to consider the disclosures required by the forthcoming FASB revision to FAS 132 *Employers' Disclosures about Pensions and Other Postretirement Benefits*.

The Board agreed that no other amendments to IAS 19 would be included in the short-term exposure draft.

Revenue recognition

The Board reaffirmed various conceptual decisions made to date on the project and agreed issues to be included in the project plan. The Board reaffirmed that:

- The definition of revenues should be based on the 'Liability Extinguishment View' or the 'Broad Performance View' or a combination thereof.
- Contracts need to be enforceable if assets and liabilities arise from them.
- Conditional rights and obligations do not meet the definitions of an asset and a liability.
- Unconditional rights and mature rights meet the definition of an asset if they are enforceable and give access to future economic benefits.

- Unconditional obligations and mature obligations meet the definition of a liability if they are enforceable and oblige the entity to make a future sacrifice of economic benefits.
- Less reliable measures of fair value should not be described as 'default measures'.

The Board tentatively agreed:

- (a) That increases in assets should not be excluded from revenues as a result of being related to decreases in assets. This applies even if the carrying amounts of assets sacrificed equal or exceed the measured amounts of the inflows of assets. Revenue is not precluded just because the cost of the item sold exceeds the revenue received in exchange for it.
- (b) That the measurement criterion for the recognition of revenues should include the following new sub-criterion: "A measure is sufficiently reliable when:
 - (i) it is the most reliable measure available in the appropriate reference market; and
 - (ii) its reliability is assessed on the basis of the definition of reliability in the *Framework*. The reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for users of financial statements, which comes through verification, that it has that representational quality."
- (c) To acknowledge that 'sufficiently reliable' has yet to be defined.

The Board tentatively agreed to consider the following matters at future meetings:

- (a) A list of increases in economic benefits that should be excluded from revenues, and reasons for the proposed exclusions.
- (b) Whether an increase in equity should be part of the elements criterion for revenue recognition.
- (c) Under the 'Broad Performance View', permitting only fungible assets to give rise to revenues before enforceable contracts with customers exist.
- (d) Whether revenues should include gains.
- (e) Revenue recognition in respect of exchanges of similar and dissimilar assets.
- (f) How to determine the unit of account for a contract or set of contracts. This will include considering when contracts should be combined or segmented, and the implications of enforceability for the unit of account chosen.
- (g) The appropriate measurement attribute for assets and liabilities related to revenue-generating activities, and when to remeasure those assets and liabilities.
- (h) How to determine the fair value of a contractual obligation to a customer. An example should be developed, showing the various components of that fair value, including the compensation for risk and the incidental costs to be incurred in settling the obligation.
- (i) Whether internally developed intangible assets (such as some customer relationships) should be included in the scope of the Standard. This includes considering whether the benefits of customer relationships should be limited to benefits arising during the period of the contract, or should also include benefits expected to arise from contracts after completion of the existing contract.

Share-based payment

Since April 2003, the Board has been reconsidering the proposals in ED 2 *Share-based Payment*, in the light of comments received. The Board has almost concluded its redeliberations, and the staff have begun drafting the text of the IFRS and the accompanying basis for conclusions and implementation guidance. At this meeting, the Board discussed issues that arose during the drafting process. The Board reached the following tentative decisions:

- (a) The IFRS should contain a definition of the term ‘employees and others providing similar services’. The term should be defined broadly to include not only individuals who are employees for legal or tax purposes, but also (i) individuals who work for the entity under its direction in the same way as individuals who are regarded as employees for legal or tax purposes, and (ii) individuals who are not employees but who render personal services to the entity similar to those rendered by employees. For example, the term encompasses all management personnel, ie those persons having authority and responsibility for planning, directing and controlling the activities of the entity, including non-executive directors.
- (b) The IFRS should include a definition of a market condition. Also, the implementation guidance should include examples that illustrate the application of the IFRS to a grant of equity instruments with a market condition, including a grant that has both a market condition and a non-market performance condition.
- (c) For rare cases only, in which the exercise date/intrinsic value method is applied, the IFRS should state that it is not necessary to apply the requirements of the IFRS relating to market conditions, modifications and cancellations because of the ‘truing up’ mechanism of the exercise date/intrinsic value method. Furthermore, if an entity settles a grant of equity instruments to which the exercise date/intrinsic value method has been applied:
 - (i) if the settlement occurs during the vesting period, the entity should account for the settlement as an acceleration of vesting, and hence should recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period.
 - (ii) any payment made on settlement should be accounted for as the repurchase of equity instruments, ie as a deduction from equity, except to the extent that the payment exceeds the intrinsic value of the equity instruments, measured at the repurchase date. Any such excess should be recognised as an expense.
- (d) The implementation guidance should include an example illustrating the exercise date/intrinsic value method.
- (e) The IFRS should not require disclosure of information about estimates of the number or percentage of equity instruments expected to vest.
- (f) The transitional provisions of the IFRS should state that the requirements to disclose the nature and extent of share-based payment arrangements that existed during the period apply also to outstanding share options and other equity instruments to which the IFRS has not been otherwise applied, eg equity instruments granted before 7 November 2002 that have vested.
- (g) For any liabilities arising from share-based payment transactions, the entity should disclose the closing balance of the liability and the total intrinsic value of vested rights to cash or other assets (eg vested share appreciation rights).

- (h) The implementation guidance should include guidance on the definition of the measurement date for transactions with parties other than employees. The Board had previously concluded that if the entity cannot estimate reliably the fair value of the goods or services received, it should instead measure the transaction by reference to the fair value of the equity instruments granted, estimated at the date the entity obtains the goods or the counterparty renders service. The Board tentatively agreed that the implementation guidance should clarify that if the goods or services are received on more than one date, the entity should measure the fair value of the equity instruments granted on each date when goods or services are received, and apply that fair value when measuring the goods or services received on that date. However, an approximation could be used in some cases. For example, if an entity received services continuously during a three-month period, and its share price did not change significantly during that period, the entity could use the average share price during the three-month period when estimating the fair value of the equity instruments granted.

The staff also advised the Board of the FASB’s recent decisions on accounting for the tax effects of share-based payment transactions. The staff did not ask the Board to reconsider the decisions made on this issue at its November meeting. The Board directed the staff to include, in the basis for conclusions that accompanies the IFRS, the Board’s reasons for not adopting the FASB’s approach for measuring the deferred tax asset. The Board also tentatively agreed that guidance and an example on accounting for the tax effects of share-based payment transactions should be added to IAS 12 *Income Taxes*.

Small and medium-sized entities

In September 2003, the Board reached the following decision about the approach to defining the small and medium-sized entities (SMEs) that are targets of the Board’s SME standards:

The Board should describe the characteristics of SMEs for which it intends the standards. These characteristics should not prescribe quantitative “size tests” but rather consider qualitative factors such as public accountability. National jurisdictions should determine which, if any, entities should be permitted or required to follow IASB SME standards.

The purpose of the discussion in December was to seek the Board’s view on the appropriate characteristics.

The Board agreed that IFRSs should be regarded as suitable for all business entities.

The Board also agreed that it would develop, as an alternative to IFRSs, a separate body of financial reporting standards suitable for those business entities that do not have a public accountability. A principle of “no public accountability” should be the overriding characteristic to identify those business entities for which IASB SME standards would be intended.

The “public accountability” principle implies that an entity is publicly accountable if:

- there is a high degree of outside interest in the entity, from investors or other stakeholders;
- the entity may have a social responsibility because of the nature of its operations; and
- the substantial majority of stakeholders depend on external financial reporting, as they have no other way of obtaining financial information about the entity.

The Board also agreed to adopt presumptive indicators of public accountability. A business entity would be regarded as

having public accountability if it meets any one of the following criteria:

- (a) It has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.
- (b) It holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities brokerage, pension fund, mutual fund, or investment banking entity.
- (c) It is a public utility or similar entity that provides an essential public service.
- (d) It is of economic significance in the jurisdiction in which it is domiciled.
- (e) One or more of its owners has expressed objection to the entity's decision to use SME standards rather than full IFRSs (all owners, including those not otherwise entitled to vote, having been informed of that decision).

Because neither the principle of “no public accountability” nor the indicators includes a size criterion, the Board asked the staff to try to find a term other than “small or medium-sized entities” to describe the class of entities for which the standards would be suitable.

Meeting dates: 2004

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

21—23 January

18—20; 23, 24 February[†]

17—19 March

21—23; 26, 27 April[‡]

19—21 May

21—25 June, Oslo, Norway[†]

20—22 July

22—24; 27, 28 September[‡]

18—20 October, Norwalk, Connecticut, USA

15—19 November[†]

15—17 December

[†] Includes a meeting with the Standards Advisory Council

[‡] Includes meetings with partner standard-setters